Policy Review and Outlook 1985

Time for Decisions

Edward A. Carmichael

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C.D. Howe Institute

SUMMARY

Policy Review and Outlook, 1985

Time for Decisions

Edward A. Carmichael

Canada is at a crossroads. To take the way that leads to long-term economic success will require tough-minded decisions in 1985. These decisions must implement a strategy that enables Canada to compete and prosper in a rapidly changing world economy. The C.D. Howe Institute's *Policy Review and Outlook, 1985* proposes such a strategy and argues that determined action and leadership by the new Progressive Conservative government early in its mandate is required to achieve stronger growth of jobs and improved living standards while keeping inflation low.

Canada faces a world of accelerating technological change, increasing efficiency in the use of natural resources, global competition for markets, rapid growth of knowledge-based industries, and leaner governments that resort less to inflationary finance. To succeed in that world, Canada must overcome key obstacles. The new federal government must take bold and innovative steps to cut its deficit in order to restore the fiscal stability and private-sector confidence so necessary for growth. It must also confront deep-seated structural problems by reforming labor-market and trade policies that block adjustment to changing realities in the international economic environment. Neither reducing the deficit nor making needed structural-policy changes will be sufficient, by themselves, to ensure Canada's long-term economic success. Actions to deal with both of these obstacles to growth are essential.

The Institute believes, therefore, that the necessary strategy to restore income and employment growth consists of three major policy thrusts beginning in 1985:

- Prompt action to reduce the federal budget deficit by $15–20 billion by fiscal year 1990–91, somewhat more than was promised by the government in its November 1984 *Economic and Fiscal Statement.*
- A joint effort by the private sector and governments to eliminate obstacles to the re-employment of Canadians. This should include increased adoption of gain sharing in the private sector to make compensation more responsive to changes in both the economic environment and the financial condition of employers, as well as actions to facilitate retraining and part-time work. It should also include government actions to reduce regulatory and institutional obstacles to economic growth and eliminate the long-term unemployment trap created by existing labor-market policies.
- An early initiative by Canada to commence bilateral negotiations with the United States aimed at reducing tariff as well as nontariff barriers to trade between the two countries.

The Institute's selection of deficit reduction, re-employment initiatives, and improved access to the U.S. market as the top priorities of economic decisionmaking in 1985 is based upon detailed examination of these issues in individual chapters of the *Review.* This analysis suggests that, while the broad direction of needed changes in economic policy and private-sector behavior is clear, many issues remain to be resolved before such changes can be implemented. These issues, the Institute believes, should be the focus of the federal government's consultations with provincial governments, and with business, labor, and consumer groups in the period leading up to the spring 1985 budget.

Charting a New Course

Chapter 1 assesses the forces shaping the international environment and, against this backdrop, reviews the government's November 1984 Statement as the "working drawing" of a new economic strategy. The world economy generated a stronger-than-expected recovery and diminishing inflation in 1984. The U.S. economy, in particular, has been the predominant engine of growth. An expansionary fiscal policy, robust business investment, and reduced inflation all contributed to the strong expansion of the U.S. economy in 1984. As a group, the industrial countries achieved real growth of 5 percent during the year, sparking a strong gain in world trade and consequent improvement in the economic situation in the developing world.

While developments in 1984 were promising, concerns for the future remain. Growing structural budget deficits, combined with relatively tight monetary policies in the United States and Canada, kept interest rates — especially real interest rates — high in all industrial countries. High U.S. interest rates contributed to the strength of the U.S. dollar, which, in turn, was an important factor in the rapid increase in the U.S. trade deficit. The strong U.S. dollar and continued intense competition from newly industrialized countries have heightened protectionist pressures, especially in the United States.

By the end of 1984, however, there were signs that fiscal and monetary policies were beginning to change. Interest rates declined significantly in response to a transition to slower, more sustainable economic growth in the United States. At the same time, newly elected governments in Canada and the United States made strong commitments to reduce their budget deficits, starting in 1985.

Canada benefited from its close economic relationship with the United States in 1984. Indeed, Canada's recovery — among the strongest in the industrial countries — was largely driven by strong growth of Canadian exports to the United States. Still, economic growth in 1984 was barely sufficient to provide jobs for new entrants to the labor force and, consequently, unemployment has remained at recession levels throughout the recovery. The Canadian challenge in 1985 is to maintain and increase the pace of economic growth even as U.S. economic growth slows to a more sustainable rate.

The federal government's November 1984 Statement contains two premises about economic growth. The first is explicitly supply-side: that the prevailing mix of public- and private-sector activity is not conducive to growth. The second premise is more implicit and directed to the demand side: that a strategy designed to improve confidence in Canada's prospects will stimulate demand by both business and consumers.

The two key elements of the government's proposed strategy are to reduce the federal deficit by cutting $10–15 billion from planned expenditures by the end of the decade and to remove obstacles to stronger private-sector investment and job creation. While these measures and the premises upon which they are based are sound, it will take considerable time to prove them correct. To speed the beneficial effects on growth, more attention will have to be paid in 1985 to efforts to boost consumer and business confidence, to encourage entrepreneurial activity, and to increase access for Canadian exports to the U.S. market.

Governments, at both the federal and provincial levels, can do much to build confidence in the private sector by demonstrating the ability to manage their own problems: to bring deficits under control, to restore stability to labor relations in the public sector, and to conduct monetary policy in pursuit of price stability. In addition to getting their own houses in order, governments must take steps to encourage innovation and risk-taking and to channel Canada's healthy level of domestic saving into productive investment projects by large and small enterprises alike.

New Approaches in the Labor Market

Chapter 2 examines ways to improve employment prospects. Although Canada's job-creation record since the recession ended has been near the top among countries in the Organisation for Economic Co-operation and Development (OECD), the unemployment rate declined only marginally during 1984. Traditional macroeconomic stimulus to reduce unemployment has proven ineffective and further stimulus is virtually ruled out by the large federal budget deficit. The attack on unemployment, therefore, must now be waged on two other fronts: improved cost competitiveness and better matching of labor supply and demand.

Improved cost competitiveness can be achieved only through public- and private-sector initiatives to reduce the cost of employing people relative to the value of what they produce, thereby making hiring people more attractive. Evidence for Canada indicates that although Canadian industry pays wages second only to those in the United States, it does not generate the productivity to support such high pay levels. These relatively high wages were maintained in the 1950s and 1960s by a high tariff wall that kept out more competitive imported goods. Today, with tariffs falling to modest levels and the Canadian dollar strong against most foreign currencies, Canada's competitive position is weak and employment opportunities correspondingly low.

Recent collective-bargaining developments in Canada are encouraging because they reflect a new pragmatism by both employers and unions as well as increased wage flexibility. But the real question is whether this moderation and flexibility will endure. In industries that have had to restructure operations to survive, there is evidence that lasting changes in the compensation system have made pay increases more responsive to economic conditions. In industries that have been more profitable — such as the automobile

industry — and in the public sector, there are indications that the moderation in compensation was no more than a temporary response to recession.

Gain sharing, and other measures that link pay increases more closely to the profitability or financial condition of the employer, can improve competitiveness, employment prospects, and, ultimately, the incomes of both the employer and the employee. The gain-sharing proposal contained in the February 1984 budget is stalled because it was viewed by unions as a threat to their authority to negotiate compensation issues and by employers as overly complex and restrictive. One important way in which business and labor groups can respond to the challenge of increasing employment opportunities is to work out voluntary gain-sharing agreements appropriate to their own individual circumstances.

Better matching of labor supply and demand can also contribute to improved job prospects. Improving the skills and mobility of the unemployed requires ongoing attention. So too does the need for clear incentives in the labor market. For example, there should always be an incentive for the unemployed to accept a job or to enroll in a training course rather than remaining on unemployment insurance (UI). Under the present UI system, incentives are blurred. The regionally differentiated eligibility criteria in the existing system effectively subsidize seasonal and unstable jobs. The existing system also discourages people from accepting part-time work — because UI benefits often exceed part-time pay — and from enrolling in training courses — because, in some cases, participation in a training program can lead to the loss of UI benefits. The UI system should be changed so that after six months of unemployment, people are given a choice between enrolling in a training program or doing community-service work while they continue to receive UI benefits. No one should be forced to accept either of these options, but those who refuse ought not to be able to collect full UI benefits for long.

An increasingly popular approach, but one that is unlikely to achieve its intended impact of reducing unemployment, is the mandatory reduction of work time through a shorter work week or increased paid time off. A reduction in work time with no reduction in pay would sharply increase unit labor costs, erode competitiveness, and reduce employment demand. Even if the impact on costs of shorter work time was offset by a proportional cut in pay, it is unlikely that a lasting reduction in unemployment would result.

The case against mandatory reductions in work time is a strong one, but it also recognizes the benefits to society of the long-term trend toward shorter hours and more flexible work arrangements based upon voluntary agreements between employers and employees. Thus, it makes sense to use some of the time saved through the introduction of new technologies to increase educational or training leave for employees affected by the change. It also makes sense to encourage people to accept part-time work by altering UI benefits to ensure that there is a monetary incentive to take a part-time job.

Trade Policy: The Carrot and the Stick

Part of the answer to Canada's unemployment problem also lies in increasing access to markets abroad. Chapter 3 examines two fundamental issues in trade policy: the "carrot" and the "stick". The carrot — improved access to export markets — although not a panacea, could provide an external source of growth for the Canadian economy. The stick — rising worldwide protectionism, especially in the United States — is a serious threat to the future improvement of Canadian living standards.

The evidence in favor of freer trade is compelling, whether the objective is multilateral reduction of tariff and nontariff barriers within the General Agreement on Tariffs and Trade (GATT) or a bilateral arrangement to liberalize trade between Canada and the United States. Econometric studies estimate that eliminating tariffs and nontariff barriers in Canada and abroad could increase Canada's national income by as much as 10 percent after several years of adjustment. Lower prices and higher incomes resulting from the elimination of Canadian trade barriers would account for about half the potential gain. Increased productivity resulting from industry rationalization — to achieve the economies of scale made possible by unimpeded access to large, high-income export markets — would account for the remainder.

The emergence in recent years of a rising tide of worldwide protectionism has added a new dimension to the trade policy debate in Canada. Even as tariffs have sunk to modest levels following the several rounds of multilateral tariff reductions under the GATT, new nontariff barriers to trade have sprung up to replace them. Since the late 1970s, Canada has been increasingly threatened by U.S. nontariff barriers to trade.

The rise in protectionist pressures has resulted from a combination of factors, including high unemployment in the industrial countries and the recent strength of the U.S. dollar. But these factors, by themselves, cannot fully explain the secular trend toward the increased use of nontariff barriers to trade. Equally important has been the restructuring of the world economy over the last two decades. Stiff competition from Japan and the newly industrializing countries has posed serious problems for European and North American producers who have found themselves with inefficient production techniques and products that have not kept up with changing patterns of demand. Poor industrial relations and large fixed capital investments have made protection a more attractive short-term option than adjustment.

A particular threat to Canada has been the increased resort to nontariff barriers by the United States in recent years. This development, if not halted and reversed, will be extremely harmful both because it restricts the growth of Canadian exports and, perhaps more important, because it leads Canadian industry to invest in the United States to ensure access to that market. An analysis of two prominent developments in 1984 — President Reagan's decision to apply nontariff restrictions on carbon steel imports and congressional passage of a controversial omnibus trade bill which includes a number of protectionist elements — leads to two conclusions. The first is that pressures for protection do not die easily. If calls for protection are rejected under existing U.S. trade law, the affected industry often lobbies for a change in the law. The second is that Canada is vulnerable to being caught in the protectionist net even if Canadian actions are not the source of injury to U.S. producers.

A clear implication of these developments is that even while tariffs become increasingly unimportant barriers to trade, they are rapidly being replaced with discretionary protective devices biased against countries, such as Canada, with small domestic markets.

Canada's response to date has been to develop new legislation to enforce its legitimate right to protect Canadian industries injured by import competition. This strategy is defensive but necessary in a protectionist world. At the same time, Canada will be the loser if it attempts to engage in retaliatory protectionism with Europe, Japan, and the United States. Thus, if Canada is to capture the potential gains from freer trade and circumvent the protectionist threat, our trade relations, especially with the United States, require rapid and dramatic change.

In 1985, against a backdrop of continuing sporadic trade conflicts, the Canadian and U.S. governments will commence discussions of more liberal trade arrangements between the two countries. These arrangements could take the form of bilateral free trade in specific sectors, as was proposed by the Canadian government in 1983. The sectoral initiative lost momentum in 1984, however, as the complexity of industry-specific issues became clear. Still, if U.S. interest exists, it would be wise for the federal government to continue to investigate the benefits and costs of sectoral free trade as part of its review of Canadian options.

The Institute believes, however, that a bolder, more comprehensive approach is required. Canada could pursue comprehensive liberalization by joining the United States in advocating a new round of GATT talks to deal with nontariff barriers and the emerging issue of trade in services.

A second avenue of approach is through a bilateral trade agreement with the United States. Any such agreement should put primary emphasis on removing nontariff trade barriers between the two countries. Full elimination of such barriers would mean that the goods and services of each country would gradually be given "national treatment" in the other's market.

Decisions in 1985 about Canada's trade relations with the United States should be viewed as part of an integrated strategy to restore economic growth prospects. The unique opportunity available this year to negotiate freer trade arrangements with the United States may not exist in 1986, particularly if the U.S. economy is in recession as the president begins to look toward the political pressures of mid-term elections. The ball is in Canada's court. The federal government must decide soon to grasp this historic opportunity, begin the necessary consultations in Canada, and proceed quickly with a proposal to the United States.

Taking Decisive Action

Chapter 4 concludes the *Review* by outlining a strategic economic policy framework for Canada in 1985. The Institute believes the strategy should consist of three main elements: a bold program to reduce the federal deficit, a Canadian initiative to commence negotiation of a new Canadian-U.S. trade agreement, and joint public- and private-sector efforts to improve employment growth.

The strategy focuses on improving the medium-term growth prospects of the Canadian economy. Its success in 1985 will be

heavily dependent on U.S. economic growth and interest rates and on the success of efforts to reduce the $200 billion U.S. budget deficit. After experiencing a slowdown in the second half of 1984, the underlying strength of the U.S. economy was already beginning to reappear by year-end. Still, economic growth in 1985 will not be sufficient, by itself, to bring down the U.S. budget deficit.

The Reagan administration's target is to cut the annual deficit in half — that is, to about $100 billion — by 1988. A lengthy political stalemate is possible and would undoubtedly have negative consequences for the world economy after 1985. Opportunities for compromise exist, however. Broad recognition in the United States that the U.S. deficit must be dealt with in 1985 provides grounds for optimism that hard political bargaining will produce a combination of significant spending cuts and tax increases.

Canada has no option but to act decisively in 1985 to curtail the federal budget deficit, now projected to remain in the range of $35–40 billion annually until the end of the decade. Failure to act would seriously harm Canada's growth prospects. Rising public debt and debt-service costs generated by these large deficits are already creating two kinds of pressure. The first is to cut government spending or raise taxes to prevent the deficit from rising further. The second is to finance the deficit by printing money — a factor which raises expectations of future inflation and interest rates.

The Institute estimates that, to restore stability to federal finances by the end of the decade, the deficit will have to be reduced by $15–20 billion. This is the minimum target that would stabilize the growth of federal public debt at a rate equal to the growth of national income and thereby slow the growth of interest payments on the federal debt.

In November 1984, the Minister of Finance adopted a less ambitious target when he promised to reduce federal spending by $10–15 billion by the end of the decade. The exclusive focus, to date, on the expenditure side of the budget is appropriate because many federal programs have not yet been carefully scrutinized to establish whether they are achieving their objectives at the lowest possible cost. The Institute's analysis indicates, however, that meeting the deficit-reduction target entirely on the expenditure side of the budget would require cuts in all areas of government spending — including social programs, which make up almost half of the total. Even with significant cuts in economic and regional development spending, restraint in the growth of defense and foreign aid

commitments, the sale of Crown corporations, reductions in the size of the public service, and improved management efficiency, the government would reach only about half of its spending-reduction target. The remainder could be achieved by imaginative reforms designed to improve the targeting and reduce the automatic growth in spending on major social programs, including pensions, family benefits, and unemployment insurance. Ways would also have to be found to fund provincial health, education, and social welfare programs at reduced federal spending levels. If the government adopted all these changes, public debt interest would also grow more slowly and the $15 billion expenditure-reduction target could be reached.

The alternative to an "expenditure-only" deficit-reduction strategy is one that cuts expenditures and increases taxes. Options for increasing taxes will also require careful examination in 1985. It remains imperative, however, to tackle the spending side of the budget first.

The fact that the federal deficit must be cut in 1985, regardless of economic conditions, creates a dilemma because of concerns that deficit reduction, by itself, could be contractionary. The Institute believes that the contractionary effect, if it arises, could be offset if the conduct of monetary policy is closely coordinated with measures to reduce the deficit. The Bank of Canada's policy objective in recent years has been to achieve a rate of monetary expansion that brings down the rate of inflation and in the process accommodates improved economic growth. A commitment by the Bank to continue to pursue this approach would guarantee a monetary policy that offsets the contractionary impact of deficit reduction. The appropriate monetary policy response depends heavily on the reaction of participants in financial and foreign-exchange markets.

If deficit reduction leads to improved confidence and reduced inflation expectations, the Canadian dollar could be expected to increase in value relative to other currencies. In that event, the Bank of Canada should resist upward pressure on the dollar and allow interest rates to move downward, thereby providing an offsetting source of economic growth. If deficit reduction does not generate increased capital inflows and a stronger dollar, the Bank would have to allow Canadian interest rates and the exchange rate to decline in order to offset fiscal restraint. The difficulty with allowing the Canadian dollar to decline too far or too fast is that participants in financial markets may mistakenly view the temporary easing of credit conditions as a fundamental change in the

longer-term conduct of monetary policy. Pushing down Canadian interest rates and the value of the dollar in this way does not represent a viable approach to offsetting fiscal restraint. Instead, the Bank would have to walk a fine line to balance the need for continued economic expansion against the risk of rekindling inflationary pressures.

The *Review* concludes that the decisions facing Canadians in 1985 will be difficult, but they cannot be ignored. Charting a new course for economic policy can be a basic test of political leadership. In a rapidly changing economic environment, the federal government is wise to consult widely as it formulates the specifics of its strategy. After the consultations are over, however, the government must take decisive action, starting with the spring 1985 budget. Just as Canada's political leaders have an obligation to implement imaginative new policies, the Canadian public has a matching responsibility to rise to the challenges of tomorrow. Whether we like it or not, all Canadians must grapple with the discomforts of an unfamiliar, but better, and more interesting world.

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Edward A. Carmichael

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Foreword

There are comparatively few times in a country's history when a government's policies can bring about a decisive change in that country's long-term economic future. One of those opportunities exists in Canada in 1985. Most Canadians are willing to make changes necessary to respond successfully to the intense pressures from global economic restructuring. But sacrifices must be clearly part of a strategic approach to a better future rather than a reaction to the past.

Canada's new federal government has a large mandate that can provide the basis for a fresh and determined new direction to a better future. But there are several key policy areas where action must be taken. This issue of the Institute's annual *Policy Review and Outlook* concludes that reduction of the federal deficit will have to be boldly managed in the 1985 budget. At the same time, a variety of reforms are required in the labor market, and institutional reform in Canada's economic relationship with the United States. These changes, if initiated now, will make Canadians better off three years from now.

The *Review* was prepared by Ted Carmichael, Senior Policy Analyst, with research assistance from Bruce Ewen, Corina Herrera, and Gail Johnson. Barry Norris, Editor, prepared the manuscript for publication with assistance from Debbie Watson and Vivian Knapp.

The thrust of the research was discussed with the Institute's Policy Analysis Committee (HIPAC) and several members provided useful comments on a draft. The views presented here are, however, the responsibility of the staff; they are not necessarily shared by HIPAC or other Institute members.

Wendy Dobson
Executive Director
January 1985

1

Charting a New Course

Canada is at a crossroads. Will we take the path requiring tough-minded changes that lead to long-term economic success or the one that attempts to maintain the status quo? In the rapidly evolving global economy of the late 1980s, the changes that will shape the world of the year 2000 are emerging clearly. These changes suggest that sustained economic growth and low inflation are possible. They include an accelerating pace of technological innovation; increasingly efficient use of natural resources; emphasis on cost-competitiveness; intensified world competition in the exchange of goods and services; the disappearance of excess credit creation, either domestically or in international markets; and large-scale shifts in the structure of production towards knowledge- and service-intensive industries.

Uncertainty marked the beginning of 1984. Worries about the strength of U.S. economic performance contributed to major concerns about Europe's recovery and about the risks to the international financial system posed by heavily indebted developing nations. By the end of the year, it was evident that there was progress on all fronts, despite highly publicized forecasts of gloom and doom. Problems remain, particularly the large budget deficits in North America and payments imbalances caused by the strength of the U.S. economy and the U.S. dollar. But the strength of the U.S. economy provided an enormous boost to growth in Canada.

Despite the progress that was made within Canada in 1984, Canadians still have a distance to cover. We have begun the adjustments necessary for survival in the world of 2000, but more are required for success. We must address the fact that natural resources will be less valuable in a low-inflation, knowledge-oriented world than they were during the inflationary 1970s. We will have to reduce costs and apply state-of-the-art technology throughout the economy. A world of "5 and 4" replacing that of "6 and 5" will not suffice in a world in which general price

increases may dwindle to nothing. The outstanding question at the beginning of 1985 is whether Canada will ride the wave of change or be swamped by it.

Like waves, economic change cannot be resisted. The Progressive Conservative party's large electoral victory on September 4, 1984 represented a widely based mandate favoring change. The November 8, 1984 *Economic and Fiscal Statement* charted a new course for Canadian economic policy. It is a plan that takes into account the worldwide evidence that government intervention has failed to solve economic problems. It thus relies on the private sector rather than on public spending to reinvigorate the economy, and on Canadians acting quickly to promote adjustment to improve job prospects and future living standards with a minimum of cost and dislocation.[1]

This new mandate for change should involve nothing less than undertaking, and encouraging Canadians to make, the changes necessary for Canada to fulfill its economic potential in the world of the year 2000. Changes based only on reaction to perceived mistakes of previous governments will be insufficient; rather, they must be made because they are essential elements of a strategy to enable Canada to compete and prosper in a rapidly evolving world economy.

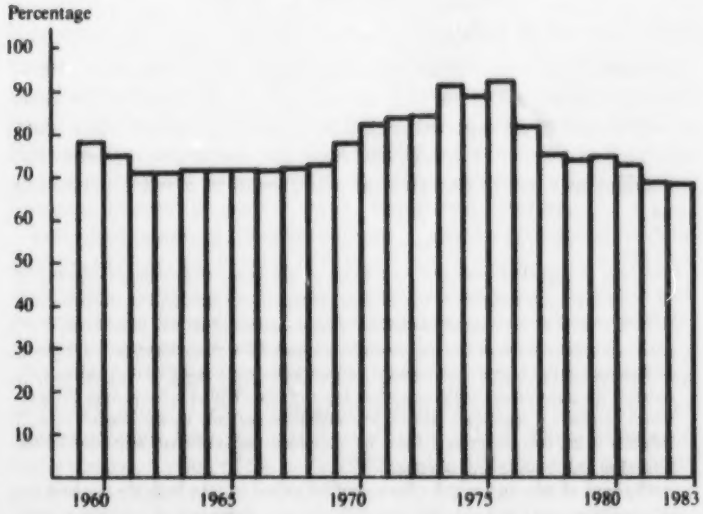
Canadians support the general idea of change, but are uncertain about who will bear the costs and who will reap the benefits. This uncertainty was strikingly evident in the debate about social programs that began in Parliament in December 1984. The debate illustrated two important lessons. First, in an environment of slow growth, the changes Canadians face involve difficult choices. Second, the debate over those choices can become alarmingly confused if the issues are not clearly defined.

For example, debate about reform of universal social programs is misplaced if such reform is removed from its proper context as one part of a strategy to sustain growth and increase flexibility. The government correctly placed deficit reduction at the top of its agenda of measures to restore Canada's growth prospects. The deficit can only be reduced by cutting spending or raising taxes. The required spending cuts and tax increases will be smaller, however, if they involve reforms to programs and to the tax system that eliminate obstacles to private-sector growth. One option is to reduce spending on social programs by better targeting

[1] The government's general approach is laid out in Hon. Michael H. Wilson, *Economic and Fiscal Statement* (Ottawa, November 8, 1984), and in the accompanying document, idem, *A New Direction for Canada: An Agenda for Economic Renewal* (Ottawa: Department of Finance, November 1984).

of benefits to those with lower incomes. Canadians are faced with a tough choice: to reduce spending by increasing the effectiveness of social assistance and other government programs, or to pay higher taxes to finance existing programs. While either option would reduce the deficit, higher taxes could prove impossible to sustain if they reduce the incentive to entrepreneurship, investment, and job creation in the private sector and damage future growth prospects.

FIGURE 1
Relative Living Standards in Canada and the United States, 1960-83[a]
(ratio of Canada to United States)



[a]Ratio of GNP per capita measured in U.S. dollars and constant 1971 prices.
Source: International Monetary Fund, *International Financial Statistics Yearbook, 1984* (Washington, C.D.: IMF, 1984).

In 1985, Canadians must address the fundamental choices posed by the government's new policy course if we are to ensure future growth in individual living standards. Canada's performance has been deteriorating since the mid-1970s, as comparisons with living standards in the United States, illustrated in Figure 1, make clear. The gap between the

two, which was narrowing prior to the mid-1970s, has been widening since then.[2]

If we are to halt this deterioration and restore growth momentum, we will have to confront squarely the challenges and terrific opportunities in the evolving international economic environment and prepare strategically for the world of the year 2000.[3] The *Review* examines some of the challenges and opportunities. This first chapter assesses the international environment and, against this backdrop, reviews the strengths and weaknesses of the government's *Economic and Fiscal Statement* as the strategy's "working drawing".

Canada and the World Economy

Developments in 1984

Growth in the world economy was stronger than expected in 1984. The rapid expansion of the U.S. economy in the first half of the year, as well as better than expected growth in Japan and in some smaller countries such as Sweden, Finland, and Australia, meant that the industrial economies as a group experienced real growth of about 5 percent in 1984.[4]

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[2] The ratio of real GNP per capita in Canada to that in the United States (see Figure 1), is an imprecise measure of the *level* of relative living standards in the two countries. The level of the ratio is influenced by relative rates of growth of nominal GNP, prices, and population in the two countries as well as by exchange-rate movements. Differences in price levels between the two countries make it difficult to estimate accurately the purchasing power of a given level of real GNP. Exchange-rate changes, which can have a significant impact, are influenced not only by the relative rates of inflation in the two countries but also by large-scale capital flows, which can be unrelated to individual living standards.

The level of the ratio is also affected by the choice of base year for the purposes of calculating real GNP — in this case 1971. In spite of the lack of precision in comparisons for a given year, the trend of the ratio over time carries an unmistakable message: after closing the gap in per capita GNP during the early 1970s, Canada had fallen back by 1984 to the levels of the early 1960s.

[3] Detailed analyses of these policies and recommendations for a new policy framework are contained in two briefs submitted to the Royal Commission on the Economic Union and Development Prospects for Canada. See Wendy Dobson, Richard Lipsey, and Murray Smith, "Flexibility as the Best Protection," *C.D. Howe Institute Commentary* (November 1983); and The Royal Bank of Canada, *Learning from Our Mistakes: A New Economic Policy Framework for Canada* (Montreal, July 1984).

[4] International Monetary Fund, *World Economic Outlook*, Occasional Paper no. 32 (Washington, September 1984), p. 1.

Economic expansion in the industrial countries produced a recovery in the volume of world trade, which grew by 8.5 percent in 1984 following four years of relative stagnation.[5] Even this increase, however, was less than would be expected on the basis of past performance. In the 1970s, world trade grew at twice the rate of industrial countries' output. In 1984, weak demand for raw materials and rising protectionism in manufactured goods trade were the most important factors holding down growth.

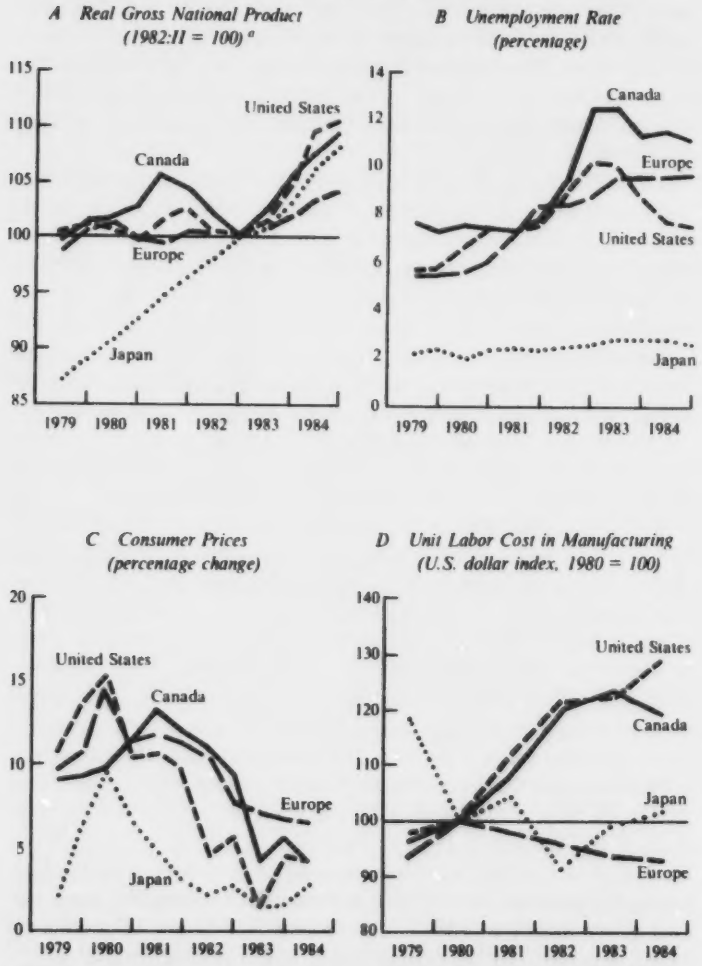
Still, the increase in import demand in the industrial countries was sufficient to help improve economic conditions in the developing world. Economic growth of almost 4 percent in the developing countries in 1984 was a significant improvement over the average annual growth of 0.5 percent during the 1981–83 period, but still well below the 6 percent pace achieved in those countries during the preceding decade. The return to economic growth has helped restore confidence in the international financial system by easing the difficult adjustments through which some heavily indebted developing countries are going. As long as their exports continue to expand and their current account balances improve, these countries are likely to have access to a steady flow of external financing needed for growth and economic restructuring.

Individual industrial countries showed significant divergences in their economic recoveries. Panel A of Figure 2 indicates that, since the trough of the 1981–82 recession, the U.S. economy has generated the most rapid growth, while the major European economies have — at least until recently — lagged badly. Canada's recovery has been almost as strong as that of the United States over this period in spite of the slowdown in the first half of 1984. To properly assess the cyclical conjuncture of these economies, however, it is also necessary to look at their experience in the recession years of the early 1980s and to consider their economic growth potential. This is particularly true for Canada, which experienced the largest drop in GNP among the major industrial countries from the peak of activity in mid-1981 to the trough at the end of 1982. While the Canadian economy's growth since the beginning of 1983 has been among the best, its level of GNP at the end of 1984 stands only 4 percent above that of mid-1981. Comparable figures are 12 percent for Japan, 8 percent for the United States, and 3 percent for Europe.

Actual growth rates should also be measured against growth potential, which varies among the industrial countries. On this basis for com-

[5] Ibid., p. 36.

FIGURE 2
Economic Performance in North America, Europe and Japan, 1979-84



Index of real GNP based on second half of 1982 equal to 100.

Sources: Organisation for Economic Co-operation and Development, *Historical Statistics, 1960-1982* (Paris: OECD, 1984); and *OECD Economic Outlook* 36 (December 1984).

parison, the U.S. economy has been growing at an unsustainable rate, well above its long-term potential. This is reflected by the sharp drop in unemployment in the United States shown in panel B of Figure 2. Canada, on the other hand, has experienced GNP growth about equal to its potential growth rate. This means that GNP growth in Canada has been barely sufficient to provide jobs for new entrants to the labor force and unemployment has consequently remained at recession levels throughout the recovery. The situation is worse in Europe, where structural rigidities have held actual economic growth below potential growth so far in the recovery. The result has been a continued rise in European unemployment — which now stands at 19 million people — a problem viewed by some as among the most serious facing the world economy.[6] Yet, as panel B of Figure 2 also shows, unemployment as a percentage of the labor force is even higher in Canada.

An encouraging feature of the current world recovery is that it has not been accompanied by any significant resurgence of inflation. The rate of increase of consumer prices in the industrial countries, shown in panel C of Figure 2, has converged at around 5 percent. Indeed, in Canada and Europe, where unemployment remains high, inflation continues to fall. In the United States and Japan, whose economies are running at much higher utilization rates of manpower and capital, inflation is held down in part by the rising values of the dollar and the yen and by the continuing weakness of commodity prices.

This synchronized deceleration of inflation in the industrial countries, however, does not mean a similar convergence in cost trends. In spite of declining inflation, Canada and the United States have experienced a sharp deterioration in competitiveness relative to Europe and Japan. A useful indicator of competitiveness, shown in panel D of Figure 2, is the performance of unit labor costs in manufacturing measured in a common currency — in this case, U.S. dollars. This measure takes into consideration the combined influence of compensation growth, productivity, and exchange-rate changes that determine relative labor costs (which make up about two-thirds of total production costs).[7] The deterioration in North American unit labor costs is largely responsible for increasing the U.S. trade deficit to $120 billion in 1984 and for a large

[6] *OECD Economic Outlook* 36 (December 1984), p. 51.

[7] Measured in local currencies, the deceleration in unit labor costs has been greater in North America than in Europe. The depreciation of European currencies against the U.S. dollar has more than offset the slower growth of North American costs and increased the relative competitiveness of European goods in world trade.

swing from surplus to deficit in Canada's trade with industrial countries other than the United States.[8] Canada's competitive position improved somewhat in 1984 because of, first, moderate increases in compensation and good productivity growth and, second, the depreciation, since last spring, of the Canadian dollar against that of the United States. The large divergences in cost performance among the industrial countries, together with continued competitive pressure from newly industrialized countries such as Brazil, Mexico, South Korea, and Taiwan, have heightened protectionist pressures everywhere.

Economic Policy in the Industrial Countries

The stance of macroeconomic — that is, fiscal, monetary, and exchange-rate — policies in the industrial countries since 1979 is depicted in Figure 3. Most striking has been the divergence of fiscal policies, illustrated in panel A of Figure 3. Expansionary U.S. fiscal policy since 1981, along with slowing inflation and increased business confidence, has contributed to making U.S. economic activity the main engine of international growth. Still, attention has focused on the implications of the U.S. federal budget deficit, which now stands at nearly $200 billion. In contrast, the tight fiscal restraint carried out in Europe and Japan since 1979 has gone largely unnoticed.

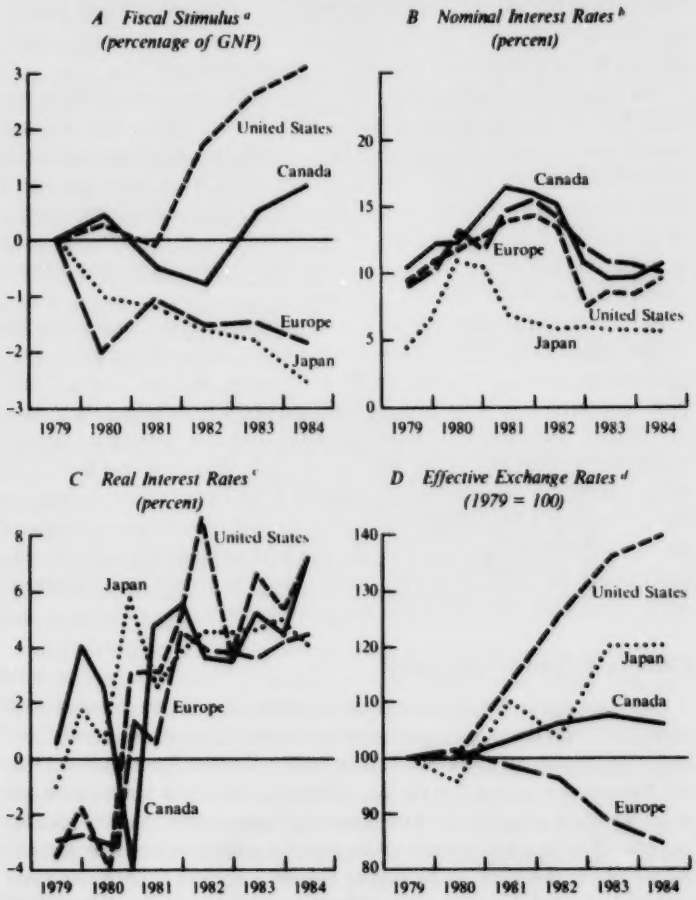
The divergence of national fiscal policies is not matched in the conduct of monetary policy. The U.S. Federal Reserve Board has played a leading role in determining interest rates around the world, as shown in panel B of Figure 3. U.S. rates have consistently been high in relation both to inflation and to foreign interest rates. In addition, central banks in all of the industrial countries have permitted interest rates to remain unusually high to reduce short-term capital outflows in response to high U.S. rates and to maintain downward pressure on inflation.

These policies have created in North America a fundamentally different combination of macroeconomic policies than in Europe and Japan. In Canada and the United States, fiscal expansion combined with relatively tight monetary policy has kept real interest rates high — as shown in panel C of Figure 3 — attracted foreign capital inflows, and put upward pressure on the effective exchange rates of the U.S. and (to a less-

[8] In 1980, Canada recorded a surplus of $5,912 million in its merchandise trade with OECD countries other than the United States. By 1984, this surplus had turned into a deficit which reached $629 million during the first six months of the year (Statistics Canada, *Summary of External Trade*, Cat. no. 67-001, various issues).

FIGURE 3

Economic Policy Indicators in North America, Europe and Japan, 1979-84



[a]Cumulative change in inflation-adjusted general government budget deficit.

[b]90-day commercial paper rate.

[c]90-day commercial paper rate minus rate of change of consumer prices.

[d]Using 1972 trade weights with allowance for third market effects.

Sources: Organisation for Economic Co-operation and Development, *Historical Statistics, 1960-1982* (Paris: OECD, 1984); and *OECD Economic Outlook* 36 (December 1984).

er extent) Canadian dollars — as shown in panel D of Figure 3. In Europe and Japan, in contrast, both fiscal and monetary policies are restrictive. The result is that the recovery to date has been strongest in North America. The economies of Europe have not experienced recovery, while growth in Japan has been well below recent standards.

The chief concern about these divergent macroeconomic policies has been that, by creating growing public debt burdens and current account imbalances in most countries, they have produced a recovery that is not sustainable. By the end of 1984, however, there were signs that these policies were beginning to change. Monetary policy eased significantly in the United States in response to the slowdown in economic growth in the second half of the year, while most other industrial countries moved quickly to match the fall in U.S. rates.

At the same time, newly elected governments in both Canada and the United States made strong commitments to actions to reduce their budget deficits, starting in 1985. In West Germany and the United Kingdom, countries that have already made progress in reducing their budget deficits, some room has been created to pursue a more expansionary fiscal policy, possibly in the form of tax cuts. However, the timing of these changes in macroeconomic policies is far from certain. To obtain the full benefit of favorable changes in the macroeconomic policies of the key industrial countries, Canada will have to take early steps to follow through on its own commitment to reduce its budget deficit and create a climate for improved private-sector growth.

Canada's Growth Strategy

Canada's lackluster economic performance in recent years and concern about persistent high unemployment underscore the importance of restoring growth momentum. The November 8, 1984 *Economic and Fiscal Statement* revealed that the new federal government holds two basic premises about growth. The first is explicitly supply-side: that the prevailing mix of public- and private-sector activity is not conducive to growth. According to this view, reduction of federal government borrowing and removal of regulatory and other obstacles to private-sector activity will revive this sector and improve investment opportunities.

The second premise is more implicit and is oriented to the demand side: that a strategy of restoring confidence in Canada's prospects for growth in jobs and income is sufficient to kindle the fires of demand — by both business and consumers.

While both premises are sound, it will take considerable time to prove them correct. Yet much of the new government's credibility, and that of the private sector, will depend on prompt results in terms of jobs — Canadians' highest priority. The following key assumptions underpinning the government's projections of Canada's performance in the absence of policy changes suggest these premises will be severely tested:

- Interest rates are expected to drop to half their 1984 levels in response to declines in U.S. rates after 1985.
- Even if Canada's real interest rates do drop, real economic growth is expected to average only 3.2 percent during the 1985–90 period.
- The unemployment rate associated with these figures will average more than 9 percent for the rest of the decade.
- Productivity growth is assumed to remain weak, and employment growth correspondingly strong.

While the interest-rate assumption is probably too optimistic, the others, although pessimistic, represent an increase in realism within the Department of Finance. In recent years, the Department has consistently underestimated the future course of interest rates, unemployment, and the federal budget deficit. Each time this has occurred, Canadians have been led to believe that persistent problems were being adequately dealt with. Yet, in the end, we have almost always found ourselves in a deeper hole than when we began.

The government's strategy for growth has two main elements: restoration of order to the "fiscal house" and redefinition of the role of government to provide a "better framework for growth and job creation." These elements are to be part of an improved climate for investment, enterprise creation, innovation, and increased international competitiveness, and are meant to be the result of a process of change that is "fair, open and consistent with the basic sense of compassion, tolerance and justice that is characteristic of Canadian society."[9]

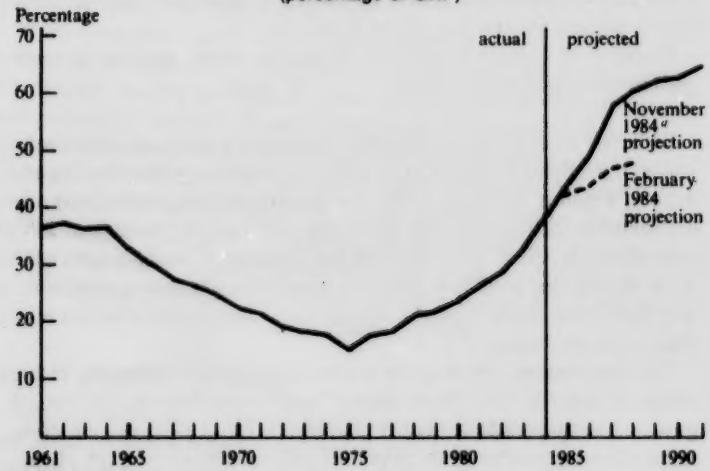
Reducing the Federal Budget Deficit

The *Economic and Fiscal Statement* placed heavy emphasis on the importance of reducing the federal budget deficit in order to restore confidence and make room for private-sector activity. Yet even though the government has set a goal of reducing annual expenditures projected for

[9] Wilson, *A New Direction for Canada*, p. 3.

1990 by $10–15 billion, concern about future deficits is growing. The government's current and projected fiscal position has deteriorated significantly since February 1984. The Statement revised upward the projected deficit for the 1984–85 fiscal year to $34.5 billion from its previously reported level of $29.5 billion. More serious, however, was the estimate that if no action is taken, the deficit will remain in the $35–37 billion range until the end of the decade. Even this estimate could be $10–15 billion too low if interest rates do not drop sharply, as Finance Minister Wilson assumes they will.

FIGURE 4
Canada's Federal Public Debt, 1961-91
(percentage of GNP)



[a]Includes expenditure cuts announced in the *Economic and Fiscal Statement*.

Sources: Department of Finance, *The Fiscal Plan* (Ottawa, February 1984), p. 62; and Hon. Michael H. Wilson, *A New Direction for Canada: An Agenda for Economic Renewal* (Ottawa: Department of Finance, November 1984).

The increase in projected deficits implies that federal public debt will grow considerably faster than GNP. As Figure 4 shows, the ratio of federal debt to GNP is now projected to exceed 60 percent by the end of the decade instead of leveling off at around 45 percent, as expected in the February 1984 budget. This is true even when the expenditure cuts announced in the Statement are taken into account.

The deterioration of the federal fiscal position in 1984 makes deficit reduction an even more urgent priority in 1985. The buildup of f eral

debt, if unchecked, will mean that over the next six years, 33 cents out of every dollar of federal revenue will be spent on servicing the public debt, even if interest rates are cut almost in half. Debt-service costs as a percentage of government expenditures are higher in Canada than in any other major industrial country.[10] The reality of compound interest rates is forcing the government to consider program cuts and tax increases to bring the deficit under control.

The Statement clearly spelled out the government's acceptance of the potentially grave implications of continued deficits. It also made clear that the measures needed to reduce the deficit require large changes in spending programs and, if necessary, in the tax system. Although the elimination of duplication and waste in spending programs is an essential task, it will not yield adequate expenditure savings to deal with the deficit, nor will currently projected levels of economic growth yield adequate revenue increases.

The next urgent question is, How will the deficit be cut? The extensive list of revenue-raising and expenditure-cutting measures announced in the Statement indicated that the government has spread the burden widely. Fifty percent of the expenditure cuts were made in the economic development envelope, 30 percent in social development, 10 percent in external affairs and aid, and 10 percent in defense and services to government.[11]

But this was only a preliminary round. Much more ambitious measures to cut the deficit are still required, and should be introduced in the budget expected in the spring of 1985. The Statement served notice that these will be the subject of extensive consultation; the accompanying discussion paper, *Agenda for Economic Renewal*, identified several major candidates for expenditure cuts, and laid out the associated issues. These include:

- *economic development spending*, which, the paper suggested, may be doing more to hinder than to promote private-sector growth;
- *social programs*, which have to be reviewed in the context of changing needs among Canadians in view of the tradeoff that has to be made between social and fiscal responsibility. The paper identifies benefits systems for the elderly and for children, as well as unemployment insur-

[10] J. de Larosière. "The Growth of Public Debt and the Need for Fiscal Discipline" (Remarks to the 40th Congress of the International Institute of Public Finance, Innsbruck, Austria, August 27, 1984, reprinted in *IMF Survey* 13 [September 3, 1984]: 261–267).

[11] Treasury Board, *Expenditure and Program Review* (Ottawa, November 1984), p. 13.

ance and housing, as program areas in need of examination. At issue, the paper suggested, is the principle of better targeting of benefits to Canadians with low incomes;

- *federal-provincial transfers*, which are to be reviewed to determine whether they should be insulated from restraint policies, how to contain the growth of costs, and how to use existing resources most effectively;
- *official development assistance*, the issue here being whether to slow the pace of increase until Canada's fiscal crisis is solved; and
- *national defense*, where the concern is how to increase spending in the most effective way possible.

This agenda of issues suggests that the Minister of Finance has concluded that the government's target for deficit reduction cannot be met without cutting social program expenditures. But the decision as to *how* will be taken only after consultation. There are risks in the consultative approach, however, as the government found out in December 1984. In order for consultation to achieve its objectives, decisions have to be delayed until the process is complete. Such delays can be interpreted as indecisive — or even cynical, if it is believed the government has already made its decision before consulting. In the consultations on social spending, the key question will have to be whether Canadians are willing to reduce spending by slowing the automatic growth of indexed programs or by better targeting of the benefits. If we are not, are we then willing to pay for these programs through higher taxes?

Removing Obstacles to Private-Sector Growth

The other main element of the growth strategy outlined in the Statement is to provide a climate conducive to innovation, investment, and competitiveness. The government intends to remove obstacles to stronger private-sector growth in order to offset the effect of reduced government activity. As examples of such obstacles, the government has identified excessive regulation, subsidies that distort investment and production decisions, and provision of services by government departments or through Crown corporations that supplant private-sector activity without a clear rationale for doing so.[12]

In December 1984, Prime Minister Mulroney announced a more positive stance toward foreign investment and the creation of Investment

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[12] Wilson, *A New Direction for Canada*, p. 22.

Canada, the body that will replace the Foreign Investment Review Agency. The government also indicated its intention to change the National Energy Program (NEP), to improve the climate for small business with tax simplification and possible measures to improve access to equity capital, to improve industrial relations in both the private and public sectors, and to shift policy emphasis away from corporate bailouts and toward measures that assist affected employees in finding new jobs.

The most fertile ground for achieving immediate gains from reduced regulation is in federal energy policy. Since the 1973–74 period, the domestic price of oil has been regulated so that, at times, it has moved quite far below world prices. At first, the policy was thought to be temporarily necessary. As world oil prices moved rapidly upward, however, the policy remained, contributing to distortions in production and consumption decisions. By 1984, weakening world oil prices and upward movements in Canadian prices negotiated since the NEP was introduced in 1980 had brought the two prices close together. The government's plan to allow domestic oil prices to rise to world levels and natural gas prices to fall to be competitive in the U.S. market now can be expected to stimulate activity in both segments of the petroleum industry without resulting in significant price increases for domestic consumers.

The decision to deregulate the price of oil was one of the most important announcements in the Statement. While consultation with provincial governments, the petroleum industry, and energy users is imperative in formulating energy policy, a consensus has already developed on a broad range of issues.[13] Moves toward greater flexibility in natural-gas pricing were initiated by the previous government and this trend can be expected to continue. The federal government's December 1984 agreement in principle with Newfoundland on issues relating to the management and fiscal regime for offshore oil development will stimulate activity in the Atlantic region, as would a final resolution of the Crown Interest, or "back-in", provision on the Canada Lands contained in the NEP.

Deregulation of the energy sector will assist the restoration of private-sector growth in Canada, but there exist a number of other elements to stimulate productivity growth and "make room" for private-sector initiatives.

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[13] For a discussion of this consensus, see Edward A. Carmichael and Corina M. Herrera, eds., *Canada's Energy Policy, 1985 and Beyond* (Toronto: C.D. Howe Institute, 1984).

Assessing Supply-Side Strategies

The overall approach to economic policy outlined in the Statement focuses on measures to increase productivity growth and improve the ability of Canadian industry to supply goods and services at world competitive prices. Supply-side strategies have been adopted in a number of countries in recent years, most notably in the United States since 1980 and in the United Kingdom beginning in the late 1970s. In the United States, the approach is credited by many with having produced one of the strongest recoveries in that country's history. In the United Kingdom, both the approach and the result have been different.

The U.S. approach had four main components: reduced growth of government spending; reduced tax rates; reduced government regulation; and slow, steady, predictable growth of the money supply.[14] The expected benefits of this approach, according to its proponents, were low inflation; a shift in economic activity towards investment and away from public and private consumption; faster economic growth; and, within a few years, a balanced budget because of reduced spending growth and faster revenue growth. Unintended effects of the strategy, however, probably contributed to its success. Tax cuts for consumers, combined with rapid growth in defense spending and smaller-than-intended cuts in nondefense spending, provided a strong stimulus to consumer demand. Accelerated depreciation allowances for business, when added to this increase in demand, generated a robust investment response. The rapid decline in inflation and the quick return of business confidence following the 1981–82 recession also aided the surge in private-sector activity.

The conduct of U.S. monetary policy since 1981 has not been the slow, steady growth of the money supply desired by supply-side proponents, either. Monetary policy was tightened in 1981 to reduce inflation; production costs and inflation expectations also dropped, contributing to flexibility, confidence, and the perception that the real rate of return to capital in the United States is one of the best in the world.

In the United Kingdom, Prime Minister Thatcher's program was also designed to strengthen the supply side of the economy.[15] This was to be achieved by reducing growth in government spending; shifting from taxes on labor income to taxes on spending and oil rents; restoring a

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[14] Herbert Stein, "Yet Another New Economics," *AEI Economist* (February 1983).

[15] William H. Buiter and Marcus Miller, "The Thatcher Experiment: The First Two years," *Brookings Papers on Economic Activity* (No. 2, 1981): 315–379.

broad balance of power in the framework of collective bargaining; privatizing nationalized industries and generally reducing government intervention; and stablizing growth of the money supply.

The Thatcher program was introduced in 1979 in an environment of high inflation, slow growth, poor labor relations, and a large budget deficit. Improvements in U.K. economic performance have been slow to materialize. Economic growth has fallen short of potential in every year of the 1980s to date. Inflation has declined to the 5 percent range from almost 20 percent in 1979, but this has been accompanied by steadily rising unemployment.

Canada's proposed strategy contains elements similar to both the U.S. and U.K. experiments. Because of its emphasis on industrial relations, privatization, and the absence, so far, of any new reduction in tax rates, Canada's strategy bears a stronger resemblance to that of the United Kingdom. The results are likely to be different, however, because Canada's economy is in better shape in 1985 than was the United Kingdom's in 1979. Inflation is already down in Canada and the economy is growing again. Although industrial relations have been a problem in the past, recent evidence indicates that labor and management in Canada are adopting a more flexible, pragmatic approach similar to that in the United States. Finally, the Canadian economy has demonstrated significantly greater flexibility and dynamism than is yet apparent in the United Kingdom.

Some economists argue that the proposed Canadian strategy pays insufficient attention to stimulating demand by consumers and business and, therefore, runs the risk that the confidence upon which it relies will not materialize as quickly as expected. Key elements in the U.S. strategy were tax cuts for individuals. But the U.S. budget was also structurally balanced at that time — something Canadian federal budgets have failed to achieve in the past several years.

At the end of 1984, it appears that more attention will have to be paid to the demand side through a major effort to obtain increased access for Canadian goods and services to the U.S. market and by domestic policy changes that boost consumer confidence and entrepreneurial investment activity.

Increasing Private Demand and Entrepreneurship

A key feature of Canada's economic recovery has been the cautious spending behavior of both consumers and business. The hesitance of con-

sumers to spend is reflected in the continued high personal savings rate, which, in 1984, stood at 12.7 percent in Canada, compared with 6.0 percent in the United States. Without a strong pull from consumer demand and with continued weakness in raw material prices, the volume of real business investment remained stagnant in 1984 at a level 13.7 percent below the average level of spending in the 1979–81 period. This is in marked contrast to business investment spending in the United States, which has been a driving force in the U.S. recovery, growing at a 12.3 percent annual rate in real terms over the past two years.

Canada's high personal savings rate relative to that of the United States is a positive factor for economic growth because it provides a pool of domestically generated funds that can be used for capital investment. Canada's problem is not that personal savings are too high but, rather,

TABLE 1
Sources and Disposition of Gross Saving in Canada, 1979–83
($ billions)

	1979	1980	1981	1982	1983
Sources by Sector					
Personal	29.7	35.7	44.8	51.8	49.3
Corporate	28.1	33.4	29.8	25.3	40.8
Government	2.8	0.3	3.9	-7.2	-13.3
Foreigners	5.4	2.0	7.2	-1.6	-1.0
Total	*66.0*	*71.4*	*85.7*	*68.3*	*75.8*
Disposition of Savings					
Capital formation	60.9	69.1	82.1	79.3	77.6
Inventory change	3.9	0.1	2.0	-9.1	-1.2
Residual error	1.2	2.2	1.6	-1.9	-0.4
Total	*66.0*	*71.4*	*85.7*	*68.3*	*75.8*
Disposition of Personal Savings					
Gross saving	29.7	35.7	44.8	51.8	49.3
Nonfinancial capital acquisition	13.4	12.1	14.8	13.0	13.0
Increase in Financial Assets	14.3	23.1	30.0	38.8	36.2
of which:					
Life insurance, pensions	11.7	13.6	15.3	14.3	16.2
Canada treasury bills	0.5	1.2	-0.4	1.0	3.2
Bonds	0.9	1.8	8.3	7.1	6.2
Stocks	-0.3	-0.3	-4.6	3.2	0.7

Source: Statistics Canada, *National Income and Expenditure Accounts*, Cat. no. 13-201, various issues.

that they are not being channeled into productive private-sector investment projects. Table 1 shows how Canada's saving behavior has fluctuated since 1979. The first section of the table, *Sources by Sector*, shows that the personal and corporate sectors are the main sources of saving in Canada. Since 1982, governments have been large net users of these savings in order to finance budget deficits, and Canada has shifted from its traditional position as that of a net foreign borrower to that of a net lender. The considerable reduction in financial requirements to fund investment and inventory stock-building in 1982 and 1983 — as shown in the second section of the table, under *Disposition of Savings* — meant that savings flowed into these alternative, less productive uses.

The problem is illustrated in the third section of Table 1, *Disposition of Personal Savings*. Capital investment by unincorporated business — which is included in the personal sector — has remained almost unchanged since 1981, while the proportion of gross savings going into financial instruments has more than doubled. These savings have flowed primarily into life insurance and pension funds, and into government treasury bills and bonds, where high and riskless rates of return can be found. They have not yet found their way into solid entrepreneurial projects and firms.[16]

Can ways be found to increase consumer and business demand and to channel savings into equity in job-creating projects and firms? One key ingredient in both cases is improved confidence and expectations. Governments, at both the federal and provincial levels, can do much to build confidence in the private sector by demonstrating the ability to manage their own problems: to bring deficits under control, to restore stability to industrial relations in the public sector, and to conduct monetary policy in pursuit of further improvements in price stability and cost competitiveness. In addition to getting their own houses in order, governments can take steps to remove institutional and regulatory obstacles to private-sector growth created by existing labor-market, trade, and industrial policies. Restructuring labor-market incentives through reform of unemployment insurance and training programs could help boost employment by lowering labor costs and upgrading the skills and employability of the jobless.

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[16]The lack of equity in Canadian-controlled enterprises has been the subject of recent public debate. See William Mackness and John S. McCallum, "Undercapitalization — A Growing Threat to the Economy," *Business Quarterly* 49 (Fall 1984): 60–63.

These types of changes could improve confidence and competitiveness in the private sector but to ensure growth, Canada also needs access to markets. Thus, the second key ingredient is action by the federal government to expand access for Canadian exports to foreign markets — particularly the United States, where protectionism has been on the rise. A new trade agreement with the United States has the potential not only of increasing sales of existing Canadian firms but also of stemming the flow of investment capital abroad by Canadian companies seeking to circumvent rising nontariff barriers to trade.

Increased investment in Canada also requires that the healthy level of Canadian savings be channeled into solid projects by large and small enterprises alike. The first step in providing greater access for entrepreneurs to Canada's savings pool is to reduce governments' claim to this pool by reducing budget deficits. The second step is to eliminate unnecessary restrictions on pension and insurance funds' investments in entrepreneurial projects. Although venture-capital financing is becoming more widespread, Canada does a much poorer job of making capital available to small firms than does the United States.

Attention to these issues will be required if the demand-side risks in Canada's growth strategy are to be reduced. The expected results may not be achieved quickly. If they are slow to materialize, the market-oriented approach could be labeled a failure and there could be demands that it be radically altered by more, not less, government intervention in the economy. But if we have learned anything from the last decade, it is that government, by itself, cannot solve Canada's fundamental economic problems; indeed, intervention often has made the situation worse.

Outline of the *Review*

Since the September 4, 1984 federal election, there have been hopeful signs that changes in economic policy are directing us down the path requiring tough-minded changes necessary for long-term success. But there are risks. One is posed by continued high unemployment at home and another is the growing protectionist threat abroad. The next two chapters of the *Review* address these risks and how to reduce them.

Chapter 2 focuses on ways to improve employment prospects. It recognizes that the size of Canada's budget deficit and conditions in the external environment rule out macroeconomic stimulus. This means that major emphasis should be placed on improving the functioning of labor markets: by increasing the flexibility of compensation arrangements; by

improving the skills and mobility of the labor force and incentives to participate in the labor market; and by encouraging greater flexibility in work time.

Important as these adjustments are, however, they cannot, by themselves, be expected to produce jobs quickly or on a large scale. Part of the answer also lies in increasing access to markets abroad. Chapter 3 examines these prospects, and addresses two fundamental issues in trade policy: the "carrot" and the "stick". The carrot — prospects of greater access to export markets — is not a panacea but it can provide a source of growth. Yet the stick — increased protectionism, particularly in the United States — is a serious threat. Particular effort to defuse that threat, and possibly dramatic initiatives to secure freer trade with the United States, will be required in 1985.

Chapter 4 concludes the *Review* by outlining a strategic economic policy framework for Canada in 1985. A key factor will be the performance of the U.S. economy, since growth prospects and protectionist reaction in that country present potentially serious constraints on the prospects for Canada. Regardless of what happens in the United States, however, the Institute believes that the federal government must make major decisions to foster the competitiveness and entrepreneurial activity that will create domestic investment and jobs; to begin to secure access for Canadian goods and services to U.S. markets; and to begin to reduce the federal budget deficit by at least the $10–15 billion target on the spending side promised in the November Statement.

These decisions will be difficult ones. Canadians continue to be willing to accept more public spending than we are prepared to tax ourselves to pay for and that evidence suggests is justified. We desire access to the fruits of U.S. growth and dynamism, but there is some hesitancy about expanded trade ties because of the doubt Canada could compete overall; protected sectors fear the discomfort of a more open economy. These attitudes create a desire to preserve the status quo. But if Canada is to ride the wave of economic change towards the opportunities of the world of 2000, determined and realistic action is required now.

2

New Approaches in the Labor Market

At the end of 1984, the number of jobs in Canada was at an all-time high. More than 600,000 jobs have been created since the trough of the recession in December 1982, and Canada's employment record since the recession ended has been near the top among the countries in the Organisation for Economic Co-operation and Development (OECD), just as it was throughout the 1970s. Yet at the end of Canada's second full year of recovery, the unemployment rate was down only marginally from a year earlier and prospects for substantially lower unemployment rates in Canada are not promising.

While recent employment growth reflects the relative strength of Canada's recovery, it has also drawn many more people into the labor market in search of work. New approaches in the labor market will be needed as part of a strategy to increase Canada's competitiveness abroad and to create still more jobs.

Because there is no single explanation for Canada's high rate of unemployment, there can be no single cure. The weakness of domestic demand for goods and services and of the prices of basic raw material exports are important factors. But the importance of deficient demand can easily be overstated. Another part of the explanation is that the demand for labor is there but either not for the skills currently offered by Canada's unemployed or not at existing levels of compensation. If unemployment exists for the first of these reasons, it is commonly called "structural unemployment"; if for the second reason, it is called "real wage unemployment".

There are three broad options for speeding employment growth in Canada. These options are not mutually exclusive; all three can be pursued simultaneously. The first is to engineer a large and lasting increase in demand to stimulate employment growth; the second is to reduce the cost of employing people relative to the value of what they produce, to

make hiring people more attractive; the third is to restructure the labor force on the supply side by some combination of retraining, occupational and regional mobility, and more flexible work time.

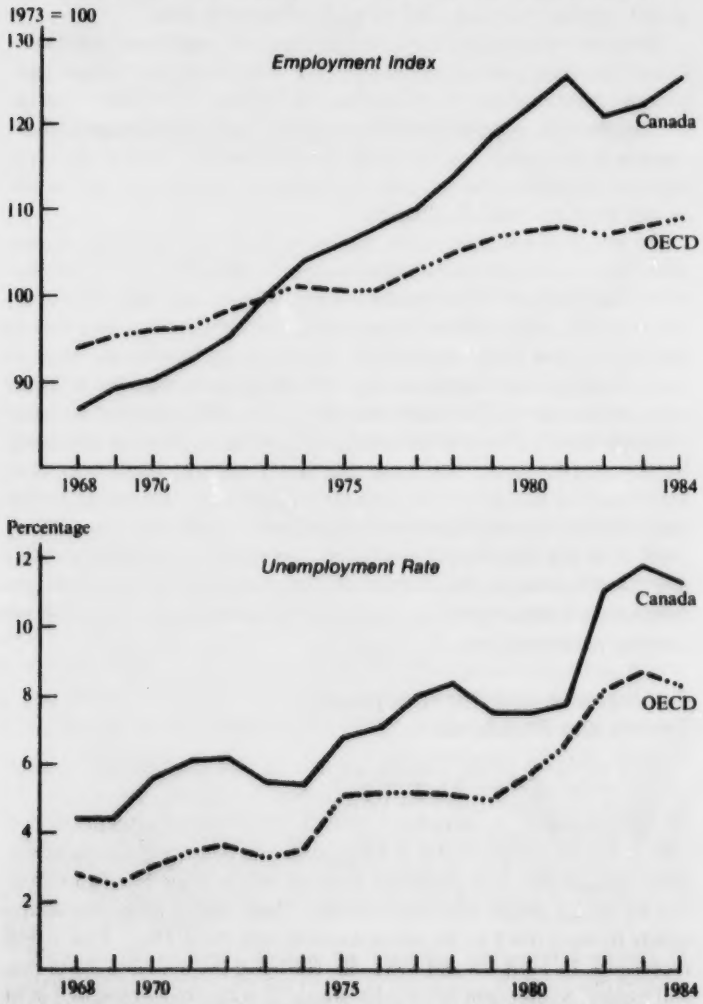
There are two avenues to increasing demand: traditional macroeconomic stimulus, and microeconomic policies that expand export markets and encourage private investment. Stimulative fiscal policy — a tax cut, for example — is virtually ruled out by Canada's large budget deficit. Canada is also limited in its ability to use monetary policy, the other big lever of macroeconomic policy, to stimulate demand for reasons discussed in more detail in Chapter 4.

The attack on unemployment, therefore, must now be waged on two other fronts: improved cost competitiveness, and better matching of labor demand and supply. This chapter focuses on these two approaches, beginning with a diagnosis of recent labor-market developments and an analysis of some longer-term trends in technology that put the employment challenge in perspective. Next, the chapter examines the evidence of the existence of real wage unemployment in Canada; the evidence is mixed. Finally, there is an investigation of the options for increasing employment by better matching the skills, mobility, and work-time preferences of the labor force with the requirements of employers. The chapter concludes that mandatory reductions in work time are unlikely to have the intended impact of reducing unemployment; instead, voluntary private-sector moves to increase both flexibility in work arrangements and emphasis on retraining could be a powerful combination for creating permanent jobs for Canadians.

Employment and Unemployment: Trends and Prospects

Since the early 1970s, Canada has had the best employment-creation record of all OECD countries but has been among the worst in terms of unemployment, as shown in Figure 5. Employment growth, though strong, has been insufficient to keep pace with demographic and attitudinal changes that have produced rapid growth in labor-force participation by young people and adult women. These forces have produced a steady upward trend in the unemployment rate since 1970. Two world recessions, in 1974–75 and 1981–82, ratcheted the unemployment rate still higher. Subsequent recoveries produced some improvement, but at each recent peak in economic activity the unemployment rate has stabilized at a higher level, suggesting that the component due to a mismatch

FIGURE 5
Employment and Unemployment in Canada and the OECD, 1968-84



Sources: Organisation for Economic Co-operation and Development, *Historical Statistics, 1960-1982* (Paris: OECD, 1984); and *OECD Economic Outlook* 36 (December 1984).

of labor supplied and labor demanded has increased.

Explanations of the increasing mismatch are numerous. Some economists point to structural causes, including the accumulation of institutional rigidities such as higher minimum wages and more liberal unemployment insurance (UI) benefits, as well as rapid changes in technology and industrial structure. Others focus on the real wage explanation of unemployment: that wages, adjusted for inflation, have grown faster than productivity, thus raising labor costs and leading firms to employ fewer people.

Because these underlying forces influencing the level of unemployment are not well understood, it is impossible to say what part of Canada's 11.3 percent unemployment rate in 1984 can be attributed to a mismatch of supply and demand. Nor is it possible to say with any confidence whether this component is still rising or has begun to fall. What can be said, however, is that in recent years, a higher proportion of Canadians have experienced unemployment at least once during the course of a year and the average length of a spell of unemployment has increased considerably.[1]

While long-term unemployment has increased significantly in Canada since 1979, the international comparison in Table 2 illustrates that the problem is less serious in Canada than in most other OECD countries. The proportion of those unemployed for a year or more was lower in Canada in 1983 than in any of the other countries shown, although Canada did have a higher proportion of people unemployed for six months or more than did the United States and Sweden. The countries that have the highest proportion of long-term unemployed also tend to be those where individuals are eligible to receive UI benefits for up to two or three years. In Canada, the maximum period for collecting UI is 50 weeks. It has been a common practice, however, for federal and provin-

[1] In 1983, 1,445,000 Canadians, on average, were unemployed each month. This is less than half of the 3,742,000 who were out of work at least once during the year. This figure, referred to as the "incidence of unemployment", increased by 23 percent between 1980 and 1983. Over the same period, the length of the average spell of unemployment increased by 36 percent to 19 weeks in 1983 from 14 weeks in 1980. Long-term unemployment accounts for an increasing proportion of Canada's overall jobless rate. In 1983, 1,030,000 people were unemployed for half the year or more, compared with 480,000 in 1980. These people represented 28 percent of the total number who experienced unemployment in 1983. But because of their long spells of unemployment, they accounted for 39 percent of the total weeks of unemployment — that is, for 6.6 percentage points of the total unemployment rate of 11.9 percent (unpublished data from Statistics Canada, *Annual Work Patterns Survey* [Ottawa, 1983]).

cial governments to employ UI exhaustees in short-term job-creation projects long enough to requalify them for UI. This practice artificially reduces Canada's measured long-term unemployment.

TABLE 2
Long-Term Unemployment in Selected OECD Countries, 1979 and 1983
(percentage of total number unemployed)

	1979		1983	
	6 months and over	12 months and over	6 months and over	12 months and over
Canada	15.6	3.5	28.0	9.5
France	55.1	30.3	67.3	42.6
West Germany	39.9	19.9	54.1	28.5
Japan	38.1	17.2	31.2[a]	14.3[a]
Sweden	19.6	6.8	24.9	10.1
United Kingdom	39.7	24.5	57.8	36.2
United States	8.8	4.2	23.9	13.3

[a]Figures for 1982.

Source: Organisation for Economic Co-operation and Development, *OECD Employment Outlook* (Paris: OECD, September 1984), p. 107.

The increase in long-term unemployment has had two important consequences for the way Canadians view future employment prospects. First, it has contributed to a disillusionment concerning the economy's ability to provide sufficient jobs to employ Canada's growing labor force. Second, the apparent unemployability of a growing segment of the labor force heightens fears that technological change is destroying more jobs than it produces. Nobel laureate Wassily Leontief, for example, emphasizes the possibility that the spread of microelectronics technology will result in persistent, large-scale unemployment:

> With the advent of solid-state electronics, machines that have been displacing human muscle from the production of goods are being succeeded by machines that take over the functions of the human nervous system not only in production but in the service industries as well...The relation between man and machine is being radically transformed.[2]

In Leontief's view, rising technological unemployment caused by the

[2]Wassily W. Leontief, "The Distribution of Work and Income", *Scientific American* 247 (September 1982): 188.

spread of microelectronics technology over the next 10 to 15 years will only be avoided if there is a significant reduction in work time.

Leontief's conclusion is not widely shared. As another Nobel Prize-winning economist, James Tobin, argues,

> mass unemployment is not technological in origin....[H]uman labor in general has never yet become obsolete. Despite the dire science fiction prophecies that accompany every period of high unemployment, revival of aggregate demand has always created jobs in numbers vastly beyond the imaginations of the pessimists.[3]

Tobin is probably right. The 1983–84 recovery in the United States was fueled by a boom in business spending on high-technology machinery and equipment. Far from eliminating jobs, this investment produced a dramatic drop in U.S. unemployment.

Recent developments and longer-term trends in the Canadian labor market indicate that it may be several more years before unemployment returns to prerecession levels. The challenge for labor-market policy in 1985 will be to restructure existing unemployment insurance, training, and mobility programs in ways that reduce labor costs, reinforce work incentives, and upgrade the occupational skills and geographic mobility of the labor force.

Real Wages and Unemployment

Unemployment can arise when the real wage — the total compensation cost of employing a person, adjusted for inflation — is too high and is prevented by institutional factors from falling to the level at which firms would employ all those looking for work. Some recent studies have demonstrated that differences in the flexibility of real wages in response to changing economic conditions are helpful in explaining differences in unemployment over the past decade. Countries that have a low degree of wage flexibility, such as the United Kingdom, West Germany, and Denmark, also experienced the largest increases in unemployment. Japan and Switzerland, on the other hand, have a high degree of wage flexibility and they experienced the smallest increases in unemployment. Canada and the United States fall into a middle category, in terms of

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[3] James Tobin, "Unemployment in the 1980s: Macroeconomic Diagnosis and Prescription," in Andrew J. Pierre, ed., *Unemployment and Growth in the Western Economies*, Europe-America no. 2 (New York: Council on Foreign Relations, 1984), p. 83.

both the degree of real wage rigidity and increase in unemployment.

Jacques Artus, an economist at the International Monetary Fund in Washington, has compared wages in manufacturing and has found that while the real wage rate is higher than the level compatible with high employment in France, West Germany, and the United Kingdom, the same could not be said for Canada and the United States.[4] While his conclusions with respect to the European countries and the United States are in accord with a wide body of professional opinion, his findings for Canada do not stand up to careful scrutiny.

For each country, Artus has developed an econometric model to estimate warranted wages — the level of real wages that would be consistent with high employment of labor given the existing capital stock. He estimates two models for Canada using data from 1955 to 1982. One indicated that, in 1982, the warranted and actual wage levels were about the same. The second, which incorporates energy as a factor of production, indicated that actual wages were *below* the warranted wage rate in 1982. The latter result reflects the notion that higher energy prices after 1973 reduced the demand for energy and energy-using capital equipment and increased the demand for labor and, with it, the warranted wage. If Artus is right, supply-side measures to increase downward flexibility in labor costs and improve productivity, such as increased use of bonus or gain-sharing systems, would not be expected to have much effect on unemployment.

A study by Canadian economist Don Daly tells quite a different story.[5] Daly's careful measurement of comparative labor costs in the major industrial countries shows that although the Canadian manufacturing industry pays wages second only to those in the United States, it does not generate the productivity (output per hour) to support these high pay levels. Consequently, Canada's unit labor costs — which take account of differences in productivity, hourly compensation, and exchange rates — are the second highest (after the United Kingdom's) among the countries Daly examines: roughly 30 percent above those of the United States and double the level in Japan. Daly concludes that Canada's deteriorating cost competitiveness is responsible for low profits, low investment, plant closures, and high unemployment.

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[4] Jacques Artus, "Are Real Wages Too High in Europe?" *Finance and Development* 21 (December 1984): 10–13; and idem, "The Disequilibrium Real Wage Hypothesis: An Empirical Evaluation," *IMF Staff Papers* 31 (June 1984): 249–302.

[5] Donald J. Daly, "Cost Competitiveness in Canadian Manufacturing: The Challenge and Some Policy Options" (York University, Toronto, October 1984, Mimeographed).

Daly's analysis also provides a hint that helps sort out the differences between his findings and those of Artus. Daly notes that Canada's competitiveness, as measured by relative unit labor cost, has always been low compared to that of the United States. But Canadian manufacturing wages could be kept above levels warranted by productivity in the 1950s and 1960s because Canadian producers had a high degree of tariff protection. With Canadian tariffs declining significantly following the Kennedy and Tokyo Rounds of multilateral trade negotiations, manufacturers are now hard-pressed to keep wages above levels warranted by productivity. The critical assumption in Artus' study is that during the late 1950s and early 1960s, actual wages were equal to their warranted level. Artus then uses this assumption to calculate warranted wages in the 1970s and early 1980s. The assumption is clearly inappropriate for Canada. Wages were above warranted levels in the earlier period but maintained by a high tariff wall. Today, with tariffs falling and the Canadian dollar strong against most foreign currencies, Canada's competitive position is weak and employment opportunities in manufacturing correspondingly low.

A third study, by a group of economists at the London School of Economics, looks at the relationship between wage flexibility — that is, the ability of real wages to adjust quickly to changes in economic conditions — and unemployment.[6] Their estimates, based on evidence over the 1957–80 period and depicted in Figure 6, show that Canada falls in the middle of the spectrum in terms of wage flexibility. Real wages in Canada are more responsive to changes in unemployment brought about by external shocks than are real wages in several of our important trading partners, including the United Kingdom and West Germany. Canadian real wages are more rigid, however, than those in Japan, Sweden, and several other countries.

The important policy implication that emerges from these analyses is that measures which increase real wage flexibility in the economy are likely to reduce both the magnitude and the duration of unemployment arising from adverse external shocks. The link between real wages and employment, however, is far from straightforward. It is uncertain, for example, how quickly wage moderation, by itself, will translate into stronger employment growth; wage moderation in Europe has not yet had much positive effect on job creation there. The prevalence of rigid

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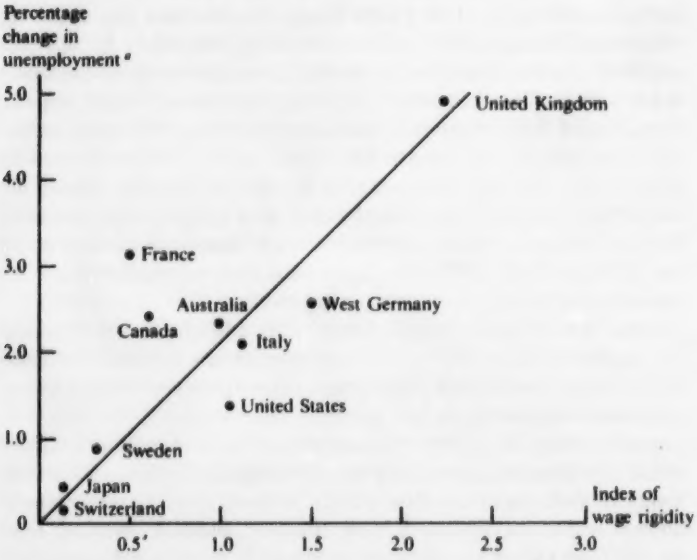
[6]Dennis Grubb, Richard Jackman, and Richard Layard, "Wage Rigidity and Unemployment in OECD Countries," *European Economic Review* 21 (1983) 11–39.

FIGURE 6
Unemployment and Wage Rigidity in Selected OECD Countries



[a]Increase in average unemployment rate in 1980-84 period compared with 1975-79 period.

Sources: Dennis Grubb, Richard Jackman, and Richard Layard, "Wage Rigidity and Unemployment in OECD Countries," *European Economic Review* 21 (1983); and *OECD Economic Outlook* (December 1984).

work rules and other regulatory constraints on employers in Europe may provide an explanation.

Recent Developments in Collective Bargaining

Collective bargaining between employers and unions is instrumental in establishing the trend of real wage increases. Recent North American evidence indicates a moderating trend and increasing flexibility and pragmatism in collective bargaining.

In Canada, moderation in compensation settlements has been appearing since 1982, but this change has not yet been accompanied by a similar increase in flexibility in the system of compensation. Wage freezes

TABLE 3
Wage Settlements and Consumer Prices in Canada and the United States, 1981-84
(percentage increase)

	Canada		United States	
	Wage settlements [a]	Consumer prices [b]	Wage settlements [a]	Consumer prices [b]
Annual				
1981	12.7	12.5	8.8	10.4
1982	9.6	10.8	6.6	6.1
1983	5.4	5.8	3.7	3.2
Quarterly				
1983: 1	6.5	7.6	4.7	3.6
2	5.7	5.9	3.5	3.3
3	6.5	5.3	3.9	2.6
4	4.0	4.6	3.1	3.3
1984: 1	3.0	5.2	2.6p	4.5
2	2.9	4.6	2.8p	4.3
3	3.1	3.9	2.9p	4.2

p = preliminary.

[a]Data are for contracts in the private sector. Differences in Canadian and U.S. methods of reporting data on wage settlements make direct comparisons difficult for two reasons. First, the coverage of collective bargaining data differs. Canadian data cover collective agreements for 500 or more employees representing all sectors excluding public administration, Crown corporations, education, health and welfare, and certain public utilities, and excluding construction prior to 1982. U.S. data cover agreements for 1,000 or more employees in all private, nonfarm industries. Second, the methods of reporting the data differ. Canadian data measure contractually stipulated wage increases over the life of the agreement, including cost-of-living adjustments (COLAs), with COLA formulas quantified using a combination of the latest CPI data and/or a projected CPI of 5 percent. U.S. data measure the rate of increase in contracts without COLAs over the life of the agreement. Canadian data are produced from base rates that apply to the lowest-paying classification used for workers in the bargaining unit. U.S. data are produced from the average wage rate for all workers affected by the settlement. These differences are important, but they do not account for a major portion of the total difference in negotiated wages in the two countries.

[b]Figures represent the annual increases in the CPI for urban consumers. The quarterly data represent the percentage increase in the CPI over the same quarter of the previous year.

Sources: Department of Labour, *Major Wage Settlements* (Third Quarter 1984), pp. 20-21; U.S. Department of Labor, Bureau of Labor Statistics, *Current Wage Developments* (November 1984), p. 40; Statistics Canada, *Consumer Prices and Price Indexes*, Cat. no. 62-010 (July-September 1984), p. 25; U.S. Department of Commerce, Bureau of Economic Analysis, *Business Conditions Digest* (April 1984), p. 19, and (November 1984), p. 84.

and contract renegotiations have become increasingly widespread features of collective bargaining. These adjustments, along with mandatory controls on compensation in the public sector, contributed to negotiated wage increases in 1984 that were lower than at any time since the Department of Labour began collecting such statistics in 1967. In the first nine months of 1984, 28 percent of all settlements — covering 32 percent of employees involved in settlements — provided for either a wage freeze or cut in the first year of the contract.[7]

Trends in union wage settlements and consumer prices for Canada and the United States are shown in Table 3. In both countries, wage settlements declined from double-digit levels in 1981 to 3 percent or less during the first nine months of 1984. The deceleration occurred more quickly in the United States than in Canada. Moreover, settlements in the United States have consistently been below those in Canada, although the gap was almost eliminated in 1984.

The Private Sector

The recent deceleration of wage increases in the private sector has been common to all industries, largely in response to poor economic and business conditions and to reduced inflationary expectations. With some notable exceptions, these wage developments have occurred in an environment of reduced union militancy. Person-days lost due to work stoppages have declined sharply since 1981, and through the first half of 1984 were at the lowest level since 1977.[8]

In the steel, rubber, and meat-packing industries, international competitive pressures, declining demand, and technological change have created intense pressures to lower costs and increase productivity.[9] In 1984, some contracts were reopened and basic wages were frozen or cut in new agreements. Cost-of-living adjustments (COLAS) remain in force but in somes cases were deferred. Recent contracts in these industries have also included changes to pension provisions that encourage early retirement. These will allow companies to rationalize and improve productivity in the near term. Gain-sharing programs and employee-

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[7] Department of Labour, *Major Wage Settlements* (Third Quarter 1984), and unpublished data from the Department.

[8] Department of Labour, *Labour Data: Work Stoppages* (August 1984), p. 13.

[9] For a detailed discussion of sectoral developments in collective bargaining, see W.D. Wood and Pradeep Kumar, eds., *The Current Industrial Relations Scene in Canada, 1984* (Kingston: Queen's University, Industrial Relations Centre, 1984), pp. 295–313.

ownership schemes were implemented or are under discussion in several companies.

Inroads by nonunion labor, aided by changes in labor legislation in some provinces, produced wage freezes or cuts in major sectors of the construction industry. In British Columbia, the provincial government increased its power to outlaw strikes and guaranteed the right of nonunion construction companies to work on the same site as union contractors. In Alberta, loss of business by union contractors prompted the provincial government to introduce legislation to permit unionized construction companies to set up nonunion subsidiaries. The legislation was eventually withdrawn when unionized construction workers agreed to substantial wage cuts. In Quebec, where a growing number of construction workers were already accepting less-than-union wages, construction firms demanded reduced official union wages in 1984 negotiations.

The Public Sector

Public-sector restraint has been another source of wage moderation since mid-1982. But this sector's contribution may have been smaller than claimed by its proponents, and its contribution to price stability appears to have been temporary. University of Guelph economists Douglas Auld and David Wilton argue that wage settlements in the public sector would have declined even without the existence of government restraint programs, although the moderation might have taken longer.[10] They also argue that the Ontario and federal government restraint programs may have held pay increases higher in the second year of the programs than would have been the case under normal collective bargaining.

The federal government's "6 and 5" restraint program expired at the end of June 1984. Many provincial restraint programs were also relaxed following wage freezes in some provinces in the 1983–84 fiscal year. The result was an increase in average settlements under provincial administration to 4 percent in the third quarter of 1984 from 2 percent at the end of 1983. The Ontario public-sector wage guidelines, which accommodate a 5 percent annual increase in compensation, also serve as an inappropriate signal to negotiators. Thus, settlements in the education, health and welfare sector averaged 5.8 percent in Ontario in the

[10] Douglas A.L. Auld and David Wilton, "Controlling Wages in the Public Sector: The Ontario Experience (Paper presented at Ontario Economic Conference on Public Sector Wage Compensation," Toronto, January 8, 1985).

third quarter of 1984, compared to 2.9 percent for all of Canada.[11]

Prospects for Continued Wage Moderation

Beyond 1984, the real question is whether moderate wage settlements and more flexible behavior by both management and labor will endure. Much of the moderation in wage settlements has been made possible by the decline in inflation. The influence of reduced inflation expectations is apparent in the significant reduction in the use of COLAs in private-sector settlements — coverage dropped to under 15 percent of new agreements in 1984 from almost 60 percent in 1981.[12] As a result, indexation of wages to consumer prices now makes a considerably smaller contribution to actual wage increases than was the case in 1981. This does not mean, however, that the potential for a wage-price spiral no longer exists. Rather, it reflects the relative stability of inflation expectations for the time being.

Another reason to suspect that wage moderation may be temporary is its concentration in two provinces: Alberta and British Columbia. The first-year increase in base wages in third quarter 1984 settlements in these provinces was 0.9 percent, compared to 4.0 percent in the rest of Canada. Alberta and British Columbia also accounted for almost 80 percent of agreements calling for a first-year wage freeze. Labor in Western Canada has been challenged by the recent relaxation of provincial labor laws. While these actions have been instrumental in bringing about wage adjustments in the short term, they have increased both the polarization between labor and management and the likelihood of catch-up pressures when economic conditions improve.

Finally, and perhaps most importantly, there is scant evidence of any lasting shift toward compensation systems that link pay increases to the performance of the enterprise or to overall economic conditions. Gain-sharing systems have the dual advantages of adding a measure of wage flexibility that can ease layoff pressures in an economic downturn and of producing long-term productivity gains by allowing employees to share the benefits.

The recent strike and subsequent settlement in the Canadian automobile industry demonstrated the reluctance of the United Auto Workers (UAW) to accept a flexible wage contract — such as that agreed to by

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[11] Department of Labour, *Major Wage Settlements* (Third Quarter 1984).

[12] Statistics Canada, *Canada Update from the 1981 Census* 1 (May 1983): 3.

its U.S. counterpart — in light of the industry's profitable position. The General Motors-UAW settlement in Canada does maintain a labor-cost advantage in Canadian plants, providing the Canadian dollar does not appreciate substantially against the U.S. dollar. Nevertheless, the agreement represented an explicit refusal to accept gain-sharing or other flexible wage systems.

This analysis of recent collective bargaining in Canada suggests that, while both employers and employees have become more pragmatic in the face of reduced inflation and the need to restructure declining industries, there is still a reluctance to adopt more flexible compensation systems.

In the November 8, 1984 *Economic and Fiscal Statement*, Finance Minister Wilson confirmed his government's commitment to the concept of gain sharing but gave no indication of how this commitment might be carried out. The gain-sharing proposal contained in the February 1984 budget is stalled. It was viewed by organized labor as a threat to its authority to negotiate compensation issues on behalf of union members. It was viewed by employers, especially small businessmen, as unduly regulatory and restrictive, and the proposed tax incentive was insufficient to overcome private-sector inertia. It is worth questioning whether a federally regulated program, complete with tax incentives, is necessary to encourage gain sharing. Some would argue that there are benefits to all Canadians from the improved productivity and wage flexibility that result from gain sharing and that this justifies a tax incentive. But Canadian employers and employees would be the main beneficiaries of gain sharing. One important way in which business and labor groups could respond to the challenge of increasing competitiveness and adaptability would be by working out voluntary agreements. An initiative of this type, led by the private sector rather than by government, could pay significant national dividends.

Restructuring Labor Supply

Microeconomic policies to increase demand and competitiveness can help reduce unemployment over a period of many years. To reduce the mismatch between demand and supply, however, steps to restructure labor supply are equally important. On the supply side, three reasons can account for this mismatch: lack of skills, lack of mobility, and the wrong incentives.

Skills

In an increasingly technological age, the demand for skilled managers, entrepreneurs, and employees is virtually unlimited. Many of Canada's unemployed, however, simply have neither the education nor the skills to meet this demand. According to the 1981 Census, about one-fifth of the Canadian population over the age of 15 is functionally illiterate — that is, they lack the ability to read and comprehend such things as basic written instructions, safety warnings, and technical manuals, or to do simple arithmetic. The unemployment rate for people with less than a grade-nine education is almost double that for those with more education.

Much attention has recently been given to improving training programs for those with a high-school education. The *National Training Act*, passed in 1982, focused on providing training for high-demand occupations. Since the recession, however, employers have not experienced sufficient demand to take on many new apprentices. About 300,000 people — between 2.5 and 3 percent of the labor force — took part in some form of government-sponsored training program in 1984.[13] The cost of these programs was over $1 billion. Yet there are still questions about whether government training programs are sufficiently geared to the real needs of the labor market.

Perhaps most important is the fact that young people lack access to training that would teach them how to start a business. The education system in Canada is geared toward preparing young people either for postsecondary education or for work in an office or factory. Little emphasis is given to developing basic entrepreneurial skills. There are now 160 schools in the United States offering courses in such skills; in Canada there are but two.[14]

Labor Mobility

When jobs are more plentiful in some parts of the country than in others, a geographical mismatch in labor demand and supply can arise unless people are prepared to move. This was a problem in Canada during the energy boom of 1978–81. In spite of significant westward migration, there still existed a considerable excess demand for labor,

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[13] Hon. Michael H. Wilson, *A New Direction for Canada: An Agenda for Economic Renewal* (Ottawa: Department of Finance, November 1984), p. 45.

[14] Leslie Wayne, "A Pioneer Spirit Sweeps Business," *New York Times*, March 25, 1984, p. 1. In Canada, York University and the University of Western Ontario have programs in entrepreneurial studies.

particularly in Alberta. During the recession, many from the Atlantic provinces, Quebec, and Ontario who had moved to Western Canada returned home when their jobs disappeared.

With unemployment at double-digit levels in virtually all provinces, geographical mobility cannot now be viewed as a major problem. In the years ahead, however, reduced emphasis on regional-development incentives and ongoing industrial adjustment will mean that employers and employees will require greater flexibility in changing location in response to market forces. There still remain important obstacles to mobility, such as possible financial losses in the sale of a house, loss of employment income of a working spouse, and institutional barriers such as provincial licensing requirements in some occupations.

Incentives to Work

Unemployment insurance greatly reduces the cost of being unemployed. In Canada, UI replaces 60 percent of insurable earnings from employment for up to one year. This means that in the initial stages of unemployment, much of the cost is borne by employers and employees, who finance the majority of UI benefits. This income-replacement function can enhance the efficiency of the labor market by allowing unemployed workers to search long enough to find a job suited to their skills.

UI can also be a source of labor-market inefficiency and mismatching, in several ways. In some parts of the country, an individual only has to work ten weeks to qualify for UI benefits for the rest of the year. This encourages an inefficient pattern of employment because it effectively subsidizes seasonal and unstable jobs. The availability of UI also reduces the incentive of the unemployed to retrain or to accept available part-time work. In Canada, there is no monetary incentive for the unemployed to enroll in a training program during the first year of unemployment. Indeed, in some cases, participation in a training program can lead to the loss of UI benefits because the unemployed person is not available for work. In Sweden, by contrast, the unemployed receive additional payments if they enter a retraining program.[15]

The combination of UI and the existing tax system also discourages many unemployed people from accepting available jobs. In many cases, UI benefits exceed what could be earned for part-time work. Further-

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[15] Marc Bendick Jr., *The Swedish "Active Labor Market" Approach to Reemploying Workers Dislocated by Economic Change* (Washington: Urban Institute, March 1983), p. 7.

more, part-time workers do not currently qualify for UI benefits, so acceptance of a part-time position can lead to a loss of entitlement to benefits. Finally, in families with two income earners, tax considerations may discourage the re-employment of the person who has become unemployed. This is because the family's marginal tax rate on the earned income of the re-employed person is very high.

Reducing the structural mismatch in the labor market will require some fundamental changes in Canada's education and training systems, the removal of obstacles to labor mobility, and a restructuring of unemployment insurance to eliminate disincentives to retraining and re-employment. Improving skill levels and mobility of the work force will take time, but the process needs to be started soon if structural problems are to be reduced in this decade. In a period of continuing high unemployment, reform of the UI system can be accomplished only if the strong political will exists. Potential changes could include making continued eligibility for UI after, say, six months contingent upon enrollment in a retraining program; a more rapid phasing out of benefits in two-income families; and higher premiums for employers and employees in industries with seasonal or unstable employment patterns.

Reduced Work Time

The intractability of the unemployment problem has led some observers to advocate a reduction in work time as a means of sharing available work (and income) more evenly.[16] Critics argue that such work sharing is a "counsel of despair" based on a fundamental misunderstanding of the nature of the unemployment problem.[17] Mandatory reductions in work time, they argue, would raise labor costs and potentially reduce employment opportunities. This would make the country poorer and shrink the tax base that supports social services.

In spite of the critics' arguments, the issue of reduced work time is unlikely to vanish in the near future. Labor organizations throughout the industrial countries are committed to work for shorter hours. At issue is a fundamental question about how the benefits of increased productivity arising from technological change should be shared between the

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[16] See, for example, Leontief. For a Canadian perspective, see Ed Finn, "Shorter Work Time," *The Facts* (Canadian Union of Public Employees) 6 (August-September 1984): 10–14.

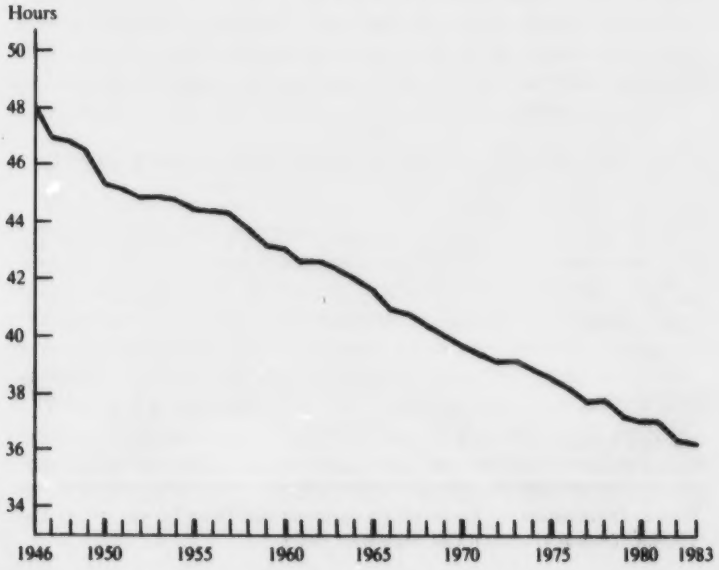
[17] Richard Layard et al., *Europe: The Case for Unsustainable Growth*, CEPS Papers no. 8/9 (Brussels: Centre for European Policy Studies, 1984), pp. 36–37.

employer and the employee who is affected by it. Advocates of reduced work time argue that such benefits should flow mainly to the employee in this form. If too little of the benefit accrues to the employer, however, there will be insufficient incentive to innovate and the growth of productivity and competitiveness will stagnate. While reductions in work time in response to labor-saving technologies are inevitable, forced reductions could prove highly counterproductive.

Trends in Work Time

In 1870, the standard length of the work week in Canadian manufacturing was 64 hours; by 1983, this figure had fallen to 38.3 hours. Figure 7 shows the trend in work time since 1946. Table 4 compares changes in work time in Canada and other major industrial countries for selected

FIGURE 7
Average Hours of Work per Week in Canada, 1946-83



Sources: Statistics Canada, *Aggregate Productivity Measures 1984*, Cat. no. 14-201 (Ottawa, November 1984); and idem, *The Labour Force*, Cat. no. 71-001, various issues.

periods since 1960. As these figures indicate, work time has been declining steadily in Canada, as in all industrial countries, although the rate at which work time has been reduced varies significantly. Since 1970, actual hours worked per person have declined fastest in European countries. Reductions have been steady but slower in Canada and slowest of all in the United States. In Japan, there was a sharp contraction of hours of work in the early 1970s, partly attributable to the first oil shock. Since 1976, as labor markets tightened and overtime increased, work time in Japan has stabilized.

Reductions of work time in OECD countries have come about in a number of ways, including a shorter normal work week, increases in paid vacation or paid educational leave, and increases in part-time work.[18] Normal hours of work and paid vacation partly reflect statutory limits on work time, but mainly result from collective agreements for the unionized work force and employers' decisions in the nonunion sector. The increased use of part-time work reflects the shift of employment toward the service sector and differences in wages and benefits paid to full-time and part-time workers.

In those countries that have experienced the fastest reduction in work time, all of these factors have been important. In Japan, France, West Germany, Italy, the Netherlands, Sweden, and the United Kingdom, there

TABLE 4
Average Actual Hours of Work in Selected OECD Countries, 1960-81
(average annual percentage change)

	1960-70	1970-73	1973-76	1976-79	1979-81
Canada	-0.8	-0.5	-0.7	-0.6	-0.6
France	-0.5	-1.0	-1.1	-0.8	-0.2
West Germany	-0.9	-1.5	-0.8	1.2	-1.2
Japan	-0.8	-1.8	-1.6	-0.3	-0.3
Italy	-0.6	-2.2	-0.8	-0.1	-0.1
Netherlands	-1.4	-2.0	-1.7	-1.9	0.9
Sweden	-0.9	-1.7	-0.7	1.6	-0.7
United Kingdom	-0.1	-0.3	-1.1	-0.9	-2.9
United States	-0.5	-0.2	-1.1	-0.2	-0.6

Source: Organisation for Economic Co-operation and Development, *OECD Employment Outlook* (Paris: OECD, September 1983).

[18] Organisation for Economic Co-operation and Development, *OECD Employment Outlook* (Paris: OECD, September, 1983), p. 38.

have been significant reductions over the past 25 years in normal hours worked in manufacturing. This has not been the case in Canada or the United States. Legislated vacation entitlements have also increased significantly in Japan and Europe. In North America, paid vacation time has not increased to the same extent.

While reductions in normal hours and increases in vacation time have been relatively modest in Canada, the increase in part-time work has made a major contribution to reduced average work time. Indeed, the increase in part-time work accounted for 54 percent of the reduction in average work time in Canada over the 1975–81 period.[19] Comparable figures for France, West Germany, and the United States are 20 percent, 15 percent, and 23 percent respectively. An increasing proportion of part-time work in Canada is involuntary, rather than indicative of a mutual desire by employers and employees for more-flexible work patterns. In 1983, the proportion of part-time workers who would have preferred full-time work was 28.5 percent, up from 11 percent in 1975.[20]

Advocates of reduced work time contend that it can be an effective weapon in fighting unemployment and that it costs less than government job-creation schemes, unemployment insurance, or welfare payments. There are undeniable benefits to society from the long-term trend to shorter work time. The real question, however, is whether policy actions to force shorter work time actually reduce unemployment.

The Case Against Reduced Work Time

Work time is a crucial component in determining unit labor costs and competitiveness. For example, a reduction in work time from 40 to 35 hours per week with no reduction in pay would result in an increase in hourly wages of over 14 percent. Such an increase in labor costs, in the absence of a comparable increase in productivity growth, would erode the competitiveness of a country's goods and services, reduce employment demand, and slow the pace of economic adjustment.

While it is possible to offset the effect of shorter hours on unit labor costs by implementing a proportional cut in pay, critics still argue that mandatory reductions in work time would not lead to a lasting reduction in unemployment. They maintain that if unemployment is temporarily

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[19] Ibid., p. 40.

[20] Statistics Canada, *The Labour Force*, Cat. no. 71-001, various issues, January 1983 to December 1983.

reduced by cutting hours per worker or by expanding output, inflationary pressures would be reignited.[21] If it is done by cutting hours and the government responds to inflationary pressures with restrictive monetary policy, then unemployment would return to its original level, but this time at a lower level of person-hours and output. The entire community would be poorer.

These are the arguments against any artificial reduction in work time implemented by a mandatory reduction in the standard work week. However, the critics add the following qualifications. First, they are in favor of the long-term trend toward shorter hours as long as it reflects voluntary arrangements between employers and employees. Second, they also favor increased flexibility in work arrangements. Thus, according to this view, it makes sense to reduce work time by increasing time for educational or training leave. It also makes sense to encourage people to accept part-time work by reforming the UI system.

Educational Leave

One attractive option for reducing annual work time is to broaden implementation of leave for education and training. Employment opportunities could be increased if educational leave — either to achieve basic functional skills or to develop and improve vocational and professional skills — takes the form of blocks of time for training courses or sabbaticals, and if firms encourage broad participation.

Broader access to educational leave would not be without costs. Moreover, because of the risk that they will not benefit from their training investment if employees move elsewhere, firms are reluctant to bear these costs. This risk discourages firms from supplying adequate training and justifies government financing part of the cost.

Greater private-sector involvement in educational leave could be promoted in various ways. One option would be to amend the tax system to include special incentives or tax credits for employers who increase training expenditures. The scope for introducing such tax measures, however, is currently limited by the need for deficit reduction.

A second option, financed primarily by the private sector, would be a levy-grant system in which all employers would contribute a given percentage of their payroll to a training fund. Firms that engage in training would be reimbursed from the fund, at least to the level of their pay-

[21] Layard et al., pp. 36–37.

ment. A federal task force on skill development leave recently proposed that such a fund be targeted to small firms or to firms engaged in skills training in high-demand occupations.[22]

The primary advantage of either of these schemes is that they would not only increase employment opportunities but would also address the problem of structural unemployment by constantly upgrading skills to match the requirements of emerging technologies.

Part-Time Work

More than half of the reduction in work time in Canada in recent years is attributable to an increase in part-time work. Part-time jobs accounted for 15.4 percent of total employment in 1983, compared with 10.6 percent in 1975. This shift reflects both the changing composition of employment and the lower cost of part-time workers.

On the demand side, the growing prominence of service industries, which employ over 80 percent of all part-time workers, has been an important factor. Many firms in these industries employ part-time staff on evenings, weekends, and at peak hours.

On the supply side, social and demographic changes have increased the number of people for whom part-time employment is attractive. There is, for example, a high correlation between increasing female participation in the labor force and the growth of part-time employment. This is particularly true for married women, many of whom have household and family responsibilities that prevent them from working full time. Part-time work is also an option for students who wish to work while pursuing educational activities and for older people who wish to phase into retirement.

Part-time work also increases employers' flexibility in controlling costs. Lower hourly compensation costs for part-time workers have undoubtedly contributed to the rapid increase in part-time employment in Canada. At the same time, lower wages and nonwage benefits for part-time workers have raised concerns about the fairness of the current system. In 1983, the Commission of Inquiry into Part-Time Work addressed these concerns by recommending that unemployment insurance be made avail-

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[22] Skill Development Leave Task Force, *Learning a Living in Canada, Volume 2, Policy Options for the Nation* (Ottawa: Department of Employment and Immigration, 1984), pp. 69–70.

able to part-timers on a prorated basis according to the number of hours worked.[23]

Part-time employment has become an important source of labor-market flexibility in Canada. To encourage this flexibility, labor-market policy should ensure that incentives to work, either full- or part-time, do not become distorted. The present system does not ensure this. Part-time work often pays less than can be received in UI benefits. Part-time work also can mean a loss of entitlement to UI benefits. For this reason, it makes sense to allow some part-time work without complete loss of UI benefits and to extend prorated UI to part-time workers.

Conclusion

Re-employing Canadians will be a major objective of this country's economic strategy in 1985 and for the rest of the decade. Reduction of the federal budget deficit will improve long-term employment prospects by freeing up financial resources. These resources will be used to increase private-sector investment and job creation only if two conditions are met: greater flexibility in the labor market and improved access to foreign markets. The policy approaches to expanding employment opportunities reviewed in this chapter — increasing cost competitiveness and improving the match of labor supply and demand — suggest mixed prospects. Despite considerable moderation in compensation agreements negotiated since 1982, government proposals to encourage gain sharing that could make the compensation system more flexible have not made much progress. Greater private-sector initiative would now be a constructive response.

At the same time, the notion of reduced work time is gaining popularity as an instrument to bring down unemployment. Ill-conceived measures to impose shorter work time would be counterproductive. But encouragement of voluntary programs that increase the flexibility of work time and that emphasize employee leave for skills upgrading could have a beneficial impact. Implementation of other changes that would improve longer-term employment prospects, such as stricter eligibility rules for UI and the extension of benefits to part-time workers, will require strong

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[23] Commission of Inquiry into Part-Time Work, *Part-Time Work in Canada* (Ottawa: Department of Labour, 1983), p.24.

political leadership. While these changes imply short-term costs for employers and employees alike, the longer-term benefits of increased labor-market flexibility and employment opportunities will be shared by all Canadians.

3

Trade Policy: The Carrot and the Stick

In the second half of the 1980s, Canadians face a lengthy period of difficult adjustments to a better public-sector fiscal balance, to a low-inflation economy, and to continued rapid technological and structural change. The prospect of a prolonged period of adjustment in an environment of relatively high unemployment and slow growth has led many to look for a breakthrough that could speed the transition and restore growth momentum.

At the same time, Canada, like other countries, faces the growing threat of international protectionism. Regional trading blocs have developed, but Canada has become isolated as the only major industrial country that does not have tariff-free access to a market of at least 100 million people. Without expanded and secure access to foreign markets, Canada can develop neither the large-scale specialized production nor the high-technology and knowledge-based activities that are essential to improved productivity and living standards.

Since the Tokyo Round of multilateral trade negotiations, tariffs have declined to very modest levels of 5–10 percent in the industrial countries, but at the same time they have increasingly been replaced by major new nontariff barriers to trade. While the increased use of nontariff measures is an international phenomenon, it is in the United States that the resort to such measures has been most dramatic. In spite of its continued rhetorical adherence to open-trade principles, the United States has responded to the pressures of recession and a strong dollar with a broad range of import restrictions. The rise of U.S. protectionism, if not halted and reversed, will be extremely harmful to Canada both because it restricts the growth of Canadian exports and, perhaps more important, because it causes Canadian industry to invest in the United States to ensure access to that market.

Renewed interest in enhanced international trade relations is therefore driven by two powerful forces. The first, a "carrot", is the notion that freer trade could speed and make less painful the difficult period of adjustment that lies ahead for Canadians. The second is a "stick", meaning that failure to act to overcome rising protectionism — especially in the United States — would progressively restrict Canada's access to world markets and deprive us of the market growth that is key to easing structural adjustment and improving living standards.

This chapter evaluates the scope for changes in trade policy that would diminish the adverse consequences for Canada of worldwide protectionism. First the carrot is sized up, by assessing the evidence and arguments in favor of freer trade, and then the stick, by analyzing recent trends in protectionism and their implications for Canada. The conclusion is that Canada, because of its small size and dependence on international trade, must do everything it can to ensure that its trading partners do not violate the open-trade principles within the General Agreement on Tariffs and Trade (GATT). At the same time, Canada cannot afford to engage in retaliatory protectionism with the large trading blocs of Europe, Japan, and the United States. If Canada is to capture the benefits of freer trade, our trade relations, especially with the United States, require rapid and dramatic changes.

The Potential Gains from Freer Trade

The notion that countries can improve their living standards by trading what they are good at producing for what they are not good at is among the most fundamental propositions of economic theory. Yet domestic political and economic pressures to restrict imports or to subsidize exports are inevitable. While such actions can benefit specific industries that face stiff foreign competition, their proliferation imposes significant costs on the economy as a whole. The magnitude of the potential gains from reducing trade restrictions has been the subject of intense debate.

The cost of tariffs and other types of protection has been the subject of increasingly sophisticated measurement over the past 25 years. Much of this analysis was stimulated by interest in the economic impact of the tariff reductions proposed in the Kennedy and Tokyo Rounds. A common feature of careful analyses carried out in numerous countries has been that the estimated costs of protection or, alternatively, the benefits

from trade liberalization are quite small.[1] Canadian studies, on the other hand, have produced a rather mixed picture of the potential gains from trade liberalization. The estimated impact of a unilateral elimination of the Canadian tariff ranges from a welfare *gain* equivalent of a 4 percent increase in the value of domestic consumption to a welfare *loss* of up to 1 percent of GNP.[2]

Another set of studies, emphasizing the importance of imperfect competition and economies of scale, provides much larger estimates of the potential gains to Canada from the elimination of trade barriers. Paul and Ronald Wonnacott of the University of Western Ontario, in a 1967 study, estimate that the Canadian tariff imposes a cost equivalent to 4.5 percent of GNP in the form of higher prices and lower incomes and that the U.S. tariff adds an additional cost equivalent to 6 percent of GNP in the form of lower productivity.[3] In a 1974 study for the Economic Council of Canada, Ronald Wonnacott estimates the cost of Canadian-U.S. trade barriers to be equivalent to 8.2 percent of GNP, while complete multilateral elimination of trade barriers could raise Canadian incomes by 10–15 percent.[4]

Interest in the issue was rekindled in 1983 by the release of the most detailed and sophisticated analysis to date. In a study for the Ontario Economic Council, Richard Harris estimates that a move to multilateral free trade in 1975 would have produced a real income gain of $13.2 billion, or 8.6 percent of GNP:

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[1] One study, for example, estimated that the Tokyo Round tariff cuts yielded a welfare gain of $4 billion, or less than one-tenth of one percent of the combined GNP of participating countries (see Alan V. Deardorff and Robert M. Stern, "A Disaggregated Model of World Production and Trade: An Estimate of the Impact of the Tokyo Round," *Journal of Policy Modeling* 3 [No. 2, 1981]: 127–152). Another found that the world gains from complete multilateral elimination of trade barriers would be approximately U.S.$20 billion (in 1973 dollars), or 1.6 percent of world GNP (see Fred Brown and John Whalley, "General Equilibrium Evaluations of Tariff-Cutting Proposals in the Tokyo Round and Comparison to More Extensive Liberalization of World Trade," *Economic Journal* 90 [December 1980]: 838–866).

[2] See James R. Williams, *The Canadian-U.S. Tariff and Canadian Industry: A Multisectoral Analysis* (Toronto: University of Toronto Press, 1976); and Robin Boadway and John Treddenick, "A General Equilibrium Computation of the Effects of the Canadian Tariff Structure," *Canadian Journal of Economics* 11 (August 1978): 424–446.

[3] Ronald J. Wonnacott and Paul Wonnacott, *Free Trade Between the United States and Canada: The Potential Economic Effects* (Cambridge, Mass.: Harvard University Press, 1967).

[4] Ronald J. Wonnacott, *Canada's Trade Options* (Ottawa: Economic Council of Canada, 1976).

> These real income gains occur through a great deal of industry rationalization and through the resulting intersectoral shifts which occur from a comparative advantage viewpoint. The productivity and rationalization effects are most significant:...(labour productivity) rises by 33 percent!....The total aggregate shifts are not enormous, but neither are they trivial. Six percent of the labour force is reallocated intersectorally....Total employment in manufacturing rises by 12 percent and of course falls in the non-manufacturing sector. The total increase in value added is about $33 billion, of which manufacturing gets about $9.7 billion.[5]

Such large potential gains to Canada appear to be inconsistent with the international estimates. However, the apparent inconsistency can be explained. The international estimates are based upon the assumption that markets for both goods and factors of production are perfectly competitive. While these may be valid working assumptions for large economic units such as the United States, the European Community, and Japan, they are less relevant to small economies such as Canada. In Canada, domestic and foreign trade barriers mean that the manufacturing sector produces largely for the protected domestic market. Because this market is small, Canadian firms cannot achieve the economies of world-scale plants and long production runs. This means that productivity is lower and costs of production higher in Canada than in many other countries.[6] Thus, the estimated gains from eliminating trade barriers are much larger in a model that incorporates imperfect competition and small-scale production, important features that exist in Canada.

Some caveats apply to the Harris estimates. First, his analysis is based on the economic and tariff structure that existed in 1975, and so the estimates do not take account of the Tokyo Round tariff cuts, which reduced worldwide tariffs on industrial products by a weighted average of 33 percent.[7] Once these reductions are completed in 1987, the gains from tariff elimination would be commensurately reduced. Second, the analysis does not take into account the dramatic increase in nontariff protec-

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[5] Richard G. Harris, with David Cox, *Trade, Industrial Policy, and Canadian Manufacturing* (Toronto: Ontario Economic Council, 1983), pp. 114–115.

[6] For evidence on this point, see Donald J. Daly "Cost Competitiveness in Canadian Manufacturing: The Challenge and Some Policy Options" (York University, Toronto, October 1984, Mimeographed).

[7] General Agreement on Tariffs and Trade, *The Tokyo Round of Multilateral Trade Negotiations* (Geneva: GATT, April 1979), p. 120.

tion that has occurred since 1975. Finally, the current discussion of trade liberalization focuses on reducing Canadian-U.S. trade barriers, whereas the Harris estimates also include the gains to Canada from elimination of trade barriers in the European Community, Japan, and the rest of the world.

The fact that tariffs were reduced substantially in the Tokyo Round implies that the Harris estimates are too large. This does not mean, however, that the overall gains from eliminating tariff as well as nontariff barriers are any smaller, for two reasons. First, while econometric estimates of the gains from elimination of trade barriers provide a useful guide to policy debate, no economic model can fully capture the dynamic benefits. Freer trade would produce a more positive attitude to change in Canada. It would also lead to a shift in emphasis away from protecting declining industries and toward providing a climate conducive to the birth of innovative ideas and enterprises that can succeed both in Canada and abroad. Economic benefits of this type attract the proponents of freer trade and suggest the possibility of a significant improvement in Canadian economic performance.

Second, the replacement of tariff with nontariff protective measures in the industrial countries imposes significant costs on small countries such as Canada. William Cline of the Institute of International Economics argues that open trade reached its postwar peak in the 1975–76 period and that,

> by 1977 trade protection had begun a relentless upward creep, and major new non-tariff barriers emerged even as tariffs themselves sank to modest levels.[8]

What is of particular concern is that, while U.S. tariffs facing Canada have declined to very low levels, the United States is among the prime offenders in raising nontariff barriers. In recent years, at least one-third of the U.S. market for manufactured goods has been covered by voluntary quotas and other quantitative restrictions. Protectionist sentiment in the United States creates uncertainty and an incentive for Canadian firms to locate new investment — and job creation — in that country.

The New Protectionism

At the core of the new protectionism are four main types of nontariff

[8] William Cline, "Protectionism: An Ill Trade Wind Rises," *Wall Street Journal*, November 5, 1984.

barriers:

- *Quantitative restrictions*, including quotas, domestic-procurement regulations, and local-content requirements.
- *Administrative and bureaucratic procedures*, including national standards, import licensing, and customs valuation.
- *Contingent-protection measures*, such as countervailing and antidumping duties and emergency-safeguard measures. Designed to counter unfair trading practices, the "contingent" aspect of these policies implies that they afford protection only if the unfair practice can be shown to exist and to be injurious to domestic producers.
- *Voluntary export restraints* (VERs), which are bilaterally arranged quantitative restrictions. Distinctive because their bilateral nature makes them discriminatory, their voluntary nature means that they represent "managed trade" negotiated outside the GATT framework.

While these are the most important direct nontariff barriers, many other types of policies are indirectly protectionist. These include investment policies that discriminate against foreign ownership and deter market entry, tax rules that favor export industries, subsidized export financing, and regional or research and development grants that confer competitive advantages upon recipient firms and shield them against foreign competition.

The Causes and Scope of the New Protectionism

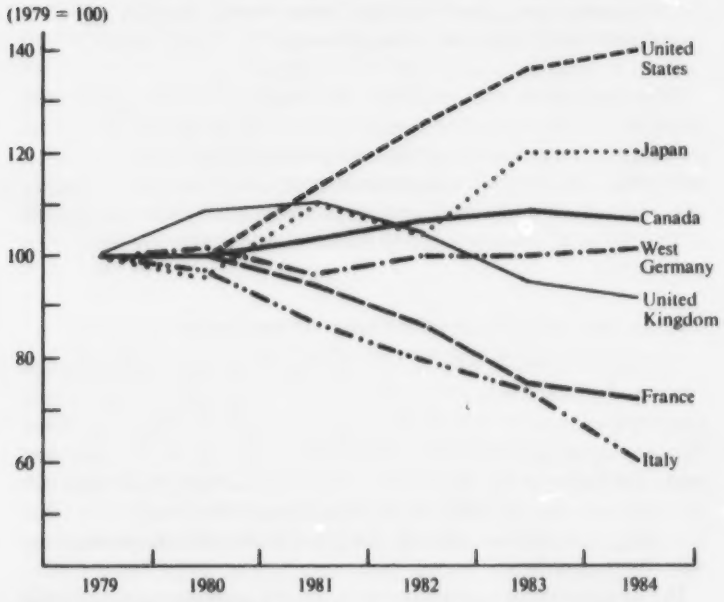
The use of nontariff trade restrictions began to accelerate in the late 1960s as the Kennedy Round tariff cuts were being implemented. Trade liberalization reached its high-water mark in the 1974–76 period. Since then, the use of nontariff actions has shown a remarkable jump in every year. The National Institute of Economic and Social Research in London estimates that by 1980, about 48 percent of total world trade was affected by protectionist devices. Six years earlier, that share had been only 40 percent.[9]

The rise in protectionist pressures is usually attributed to a combination of factors, including high unemployment in the industrial countries and the recent strength of the U.S. dollar. Figure 8 shows the effective

[9]John Hein, "Origins of the New Protectionism," *Economic Impact*, no. 43 (1983): 33–34.

exchange rates of major industrial countries since 1979. The U.S. dollar is now 40 percent more costly for foreigners than it was in the late 1970s. It is 10 percent more costly than in 1970, prior to the breakdown of the fixed exchange-rate system, when the dollar was widely believed to be overvalued. The strength of the U.S. dollar acts like a tax on U.S. exports and like a subsidy on imports. The result has been a growing trade deficit in the United States. Because of their relative cost advantage, imports penetrating the U.S. market in increasing volumes have led to calls from affected U.S. industries for protectionist measures to prevent injury and job losses.

FIGURE 8
Effective Exchange Rate of Selected OECD Countries, 1979-84



Source: *OECD Outlook* 36 (December 1984).

Depressed economic conditions and the strong U.S. dollar, however, do not explain completely the rise of the new protectionism. Jan Tumlir, Director of Economic Research for the GATT Secretariat, argues that the protectionist tendency is much more deep-seated:

> An illusion to which governments are prey, if they are not fostering it, is that the protectionism that has been with us since the early 1970s has been a pragmatic, or at any rate an inevitable, response to the increased unemployment in the wake of the energy crisis. Now this assumption...implies that as recovery proceeds, protectionism will begin to wane and will eventually disappear by itself.
>
> To believe that, I think, is both foolhardy and dangerous, because the main force behind protectionism today is the formidable force of precedent. The more groups that have already obtained protection, the stronger the case any additional claimant can make for equal treatment....
>
> To me, governments today do not appear so much protectionist as actually helpless.[10]

The rise of protectionism, then, is associated with the major restructuring of the world economy that has been under way over the last two decades. Strong competition from Japan and from newly industrializing countries (NICs) has posed serious problems for European and North American producers who have found themselves with inefficient production techniques and products that have not kept up with changing patterns of demand. Poor industrial relations and large fixed capital investments often make protection a far more attractive short-term option than adjustment.

Protectionist pressures also reflect the success of the Kennedy and Tokyo Rounds in reducing tariffs. Rodney de C. Grey, former Ambassador and Head of the Canadian delegation to the Tokyo Round, argues that it does not seem to have been realized that, as tariffs came down, some other devices would have to be used to meet the demands of domestic producers who could make a politically convincing case for protection.[11] Economists should have been able to predict the substitution of nontariff barriers for tariffs. The political economy of protection, a literature to which Canadian economists have made a significant contribution, predicts that political considerations favor protectionist responses to competitive challenges because protectionism benefits small, identifiable, regionally concentrated groups, while the costs are spread thinly over a diverse group of unorganized consumers.

The Tokyo Round may have stimulated protectionism in another way

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[10] Jan Tumlir, "Competing in a Changing World: Three Views," *Economic Impact*, no. 48 (1984): 13.

[11] Rodney de C. Grey, "The General Agreement After the Tokyo Round," in John Quinn and Philip Slayton, eds., *Non-Tariff Barriers After the Tokyo Round* (Montreal: Institute for Research on Public Policy, 1982), p. 7.

as well. Nontariff "codes" — covering such matters as subsidies, licensing, customs valuation, national standards, and government procurement — were intended to curtail the use of nontariff measures. However, by legitimizing these forms of protectionism, which were already in place in the United States and other countries, the codes may have had the long-term effect of increasing such barriers.

Some analysts believe that the nature of these negotiations necessarily tended toward legalism and proceduralism. The result was that principles were compromised and language left vague in order to achieve agreement among the many countries involved. To achieve consensus, the codes also had to include many exceptions and escape clauses. The end result has been that the nontariff codes have given all countries legal justification to strengthen their protectionist measures to make full use of their rights under the GATT. Both Canada and the United States, for example, have strengthened their legal barriers to trade since the completion of the Tokyo Round.

What is even more disturbing is that many countries have increasingly circumvented GATT rules altogether through the use of VERs. These bilateral agreements to restrict exports with voluntary restraints on trade now exist on many commodities — steel, autos, and footwear and clothing being prominent examples. Such agreements not only violate the GATT principle of nondiscrimination, but also demonstrate the trend towards the compartmentalization of trade negotiations into narrow bilateral or sectoral approaches to "managed trade".

The Protectionist Threat to Canada

Increasingly, Canada is but a minor player in the development of world trade law. Negotiations in the Tokyo Round were so dominated by the United States, the European Community, and Japan that GATT has been described as the "Club of Three".[12]

The Canadian delegation to the Tokyo Round favored sectoral negotiations that would deal with all trade barriers within a sector and reduce special problems facing Canada. Of particular concern to Canada was "tariff escalation" — the tendency for tariff rates on resource-based products to rise as the degree of processing increases. This bias has meant that resource-exporting countries such as Canada have been constrained

[12] See Senate, Standing Committee on Foreign Affairs, *Canada-United States Relations, Volume III, Canada's Trade Relations with the United States* (Ottawa: Supply and Services, 1982), p. 23.

in their attempts to increase domestic processing and manufacturing based on domestic resources. Escalating trade barriers have resulted in these activities being located mainly in major resource-importing countries.

The United States and other countries opposed sectoral negotiations on the grounds that they would limit multilateral, multisectoral tariff reductions. Thus, because of Canada's relatively small size, its favored bargaining strategy was overturned.

Canada's small size poses another problem with respect to the nontariff codes agreed to in the Tokyo Round: the contingent-protection measures are significantly biased in favor of large countries. Countervailing duties, for example, imposed against imports of goods that are subsidized and exported by other countries are a much more effective obstacle to the exports of small countries such as Canada than they are to those of large nations or trading blocs.[13] This is because subsidies that encourage world-scale production in small countries are, inevitably, subsidies to goods that must be exported — since the domestic market is small — and thus are vulnerable to countervailing duties. In large countries, on the other hand, subsidies are much more likely to be used to provide domestic producers with an advantage over imports. Such subsidies are not subject to contervailing duties.

If the move away from traditional forms of tariff protection is accompanied by an escalation of the use of nontariff measures, Canada's prospects for achieving freer trade would be seriously reduced. Recent developments indicate that just such an escalation is under way, particularly in the United States.

Protectionist Pressures in the United States

In the first half of 1984, the volume of U.S. imports grew at an annual rate of 23 percent. The U.S. trade deficit is expected to reach $120 billion in 1984, and the U.S. trade balance is in deficit with virtually every one of that country's major trading partners, as shown in Figure 9. These deficits add to mounting pressures from domestic U.S. industry to slow down import penetration through nontariff protection.

U.S. protectionism began a relentless upward creep in 1977 and this trend accelerated in 1982.[14] In the late 1970s, the Carter administra-

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[13] Rodney de C. Grey, *Trade Policy in the 1980s: An Agenda for Canadian-U.S. Relations*, Policy Commentary no. 3 (Montreal: C.D. Howe Institute, 1981) pp. 56–59.

[14] Cline.

tion adopted quantitative restrictions on shoes and color television sets, and a "trigger-price mechanism" to protect against low-cost steel imports. The Reagan administration has consistently expressed free-trade principles, but the gap between stated principles and reality has grown progressively wider: "voluntary" quotas were imposed on Japanese cars, new quotas placed on sugar imports, and existing protection on textiles and clothing tightened. There have been moves to liberalize trade in some sectors, and the administration made efforts to beat back campaigns for increased protection of copper and softwood lumber, but these have been overwhelmed by a spate of new claims of injury. Motorcycles and specialty steels are recent additions to the protected list. The U.S. Congress considered 160 pieces of protectionist legislation in 1984 alone.[15]

The Steel Ruling

Perhaps the most prominent ruling in 1984, and one of substantial importance to Canada, was that of the U.S. International Trade Commission (ITC) on carbon steel imports. U.S. steelmakers have experienced a series of crises since the early 1970s.[16] The trigger-price mechanism established in 1977 was designed to protect the U.S. industry from subsidized European steel, one of the causes of its distress. The U.S. Treasury Department established trigger prices based on the production costs of the Japanese, who operated the world's most efficient steel industry. Any imports entering the United States at prices below the trigger price were deemed to be dumped at less than the cost of production, thus enabling U.S. producers to claim injury. The system was abandoned in 1978 when the yen appreciated significantly relative to the U.S. dollar, making Japanese steel a less-restrictive guide to production costs.

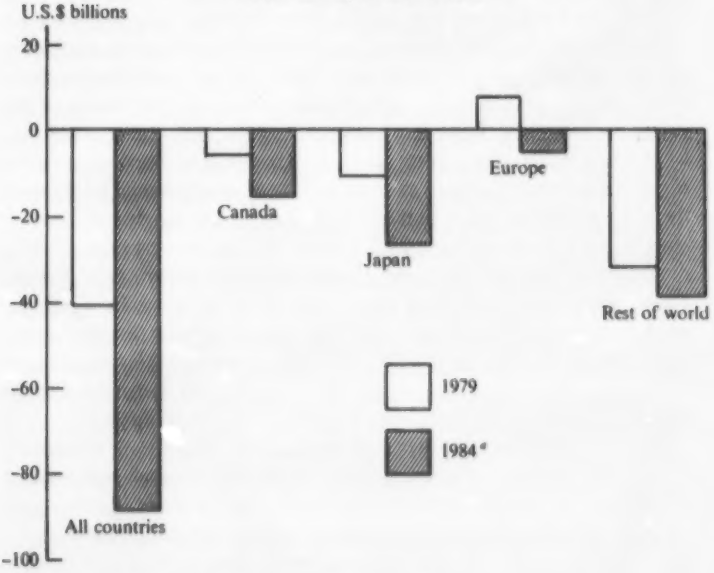
Steel imports to the United States after this date, however, continued to cause problems for domestic producers. In 1982, the United States reached an agreement with the European Community limiting carbon steel shipments to an average of 5.4 percent of the U.S. market.[17] Japan also voluntarily held down steel exports to the United States, as did Canada. In spite of these arrangements, steel imports increased to 20 percent of the U.S. market in 1983 from 17 percent in 1978. The strength of

[15] "America's Waterfront Changes but Imports Keep Pouring In," *The Economist*, September 8, 1984, p. 65.

[16] Robert W. Crandall, *The U.S. Steel Industry in Recurrent Crisis: Policy Options in a Competitive World* (Washington, D.C.: Brookings Institution, 1982).

[17] Art Pine, "Steel Import Deliberations Involve Conflict of Politics and Philosophy," *Wall Street Journal*, September 10, 1984, p. 29.

FIGURE 9
U.S. Merchandise Trade Balance with Major Regions of the World, 1979 and 1984



[a]Twelve months ending June 1984.

Source: U.S. Department of Commerce, *Survey of Current Business* 64 (September 1984).

the economic recovery together with the overvalued U.S. dollar produced a sharp increase in steel import penetration to a record level of 25 percent of the domestic market in 1984. The largest increases in imports came from two NICs — Brazil and South Korea — and from Spain.

In July 1984, the ITC ruled that U.S. steelmakers had been injured by foreign competition and, in a split verdict, recommended that President Reagan impose both tariff and quota relief for the industry — in an effort to reduce the import share of the U.S. market to 19.8 percent. The timing of the ITC recommendations meant that the president, who by law has two months to decide on an ITC ruling, would have to opt either for protection or free trade just before the U.S. election.

Canada, whose steel exports increased to 3.5 percent of U.S. consumption in 1984 from 3 percent in 1983, was clearly vulnerable to

sweeping restrictions on U.S. imports. About 2,000 jobs in the Canadian steel industry were in jeopardy, and Canadian industry and government officials mounted an effective lobbying effort in the summer of 1984 to head off quotas that would affect Canada.

President Reagan's September 18, 1984 decision to reject steel quotas was initially greeted as a blow to protectionism, and the Canadian steel industry reacted with satisfaction and relief. As the details of the ruling became clear, however, it was evident that the "surge controls" — controls that would prevent large increases in steel imports from individual countries — chosen as an alternative to quotas would have much the same protective effect as the ITC recommendations: that of limiting steel imports to an expected 20.2 percent of U.S. consumption.[18] The controls were primarily directed toward subsidized imports from Brazil, Spain, and Argentina but will also restrict efficient, nonsubsidized imports from South Korea, Japan, and Canada. Although the restraint agreements are to be negotiated with individual countries, their acceptance is not altogether voluntary, as the United States can undertake formal retaliation under U.S. trade law if negotiations break down.[19]

The Reagan decision, rather than marking the end of U.S. protection of its steel industry, is more properly viewed as another step toward managed trade in steel similar to that which exists in shoes, textiles, and clothing. Gary Hufbauer of the Institute for International Economics argues that the newly imposed surge controls, along with voluntary restraints accepted by the European Community, Japan, and Canada, form the building blocks of a multilateral steel arrangement.[20]

Canada moved quickly to accept managed trade, by promising to monitor trends in Canadian steel exports and to consult regularly with U.S. trade officials. While we may be able to retain a 3 percent share of the slow-growing U.S. steel market, there is little prospect in the near term that we will increase that share, no matter how competitive our exports.

The Omnibus Trade Bill

The protectionist sentiment of the U.S. Congress was clearly demon-

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[18] Cline.

[19] Fred Harrison, "Steel Relief May Turn to New Fears," *Financial Post*, September 29, 1984, p. 1.

[20] Jennifer Lewington, "Canada May Find Barbs in Steel Ruling," *Globe and Mail* (Toronto), September 20, 1984, p. B16.

strated by elements of an omnibus trade bill that was approved and became law in October 1984. Described as the "anti-trade" bill, it contains an extraordinary combination of free-trade initiatives and protectionist measures.[21] Two trade-enhancing measures the Reagan administration supported are the extension of the Generalised System of Preferences, which provides favorable tariff treatment to developing countries, and authority to negotiate a free-trade arrangement with Israel and with other countries including, possibly, Canada.

The Reagan administration's strong desire to obtain congressional approval of these measures opened the door for protectionist forces in Congress to insert measures of their own. Several of these measures do not conform to GATT rules and could be detrimental to Canada, including a tightening of the president's proposal for surge controls on steel that would limit imports to 17–20 percent of the U.S. market, rather than the 20 percent initially proposed.

Another important revision to U.S. trade law requires that the ITC emphasize levels of import penetration and job losses in determining injury, rather than the former practice of focusing on industry profitability. This revision could mean that industries such as footwear and copper, denied protection in 1984, could come back in 1985 with stronger legal backing.

Two measures in the bill that were defeated in October 1984 are set to return for consideration in 1985.[22] The first is a proposal on "upstream subsidies". If made law, it would enable U.S. grape growers to claim injury and protection from subsidized wine imports. More important, such legislation would establish a principle enabling U.S. producers to seek protection from imports of manufactured products that have a cost advantage because of subsidies to raw material inputs. The second proposal deals with natural-resource subsidies and is meant to address complaints from U.S. manufacturers who compete with imports from countries that hold the price of energy and other natural resources below the world price. Some U.S. firms argue, for example, that manufactured imports from Mexico, such as ammonia and cement, have an unfair advantage because Mexico holds down the price of natural gas to domestic users.

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[21] Stewart Fleming and Nancy Dunne, "'Anti-Trade' Bill Rushes Through U.S. Congress," *Financial Times of London*, October 1, 1984, p. 4.

[22] Jennifer Lewington, "Protectionist Moves Set to Return in Next Congress," *Globe and Mail* (Toronto), November 20, 1984, p. B9.

Two conclusions can be drawn from the experience with the omnibus trade bill. The first is that pressures for protection do not die easily. If calls for protection are rejected under existing U.S. trade law, the affected industry often lobbies for changes in the law. The second is that Canada is vulnerable to being caught in the protectionist net even if Canadian actions are not the source of injury to U.S. producers. This is true in the case of steel-import restraints and in the proposals relating to natural resource and other upstream subsidies.

The clear implication of these developments is that even while tariffs become increasingly unimportant barriers to trade, they are rapidly being replaced with discretionary protective devices biased against countries, such as Canada, with small domestic markets. The U.S. market, in particular, is gradually moving toward managed trade in a growing number of sectors. These developments are a response to competitive pressures arising from the cost advantages of the NICS and from the strong U.S. dollar. Although their origin has little to do with Canadian-U.S. trade relations, Canada must learn to deal with them nevertheless.

The Canadian Response

Is Canada, like other countries, helpless to halt the increasing use of nontariff protective measures? Canada's approach to date has been to ensure that mechanisms exist to enforce the rights agreed to in the Tokyo Round. This strategy is defensive but necessary in a protectionist world. The risk associated with this approach is that the legitimate application of nontariff protection hurts Canada more than it hurts our trading partners. A more positive approach is needed to escape the harmful consequences for Canada of rising U.S. protectionism. This could involve the elimination of all trade barriers within specific sectors between Canada and the United States through agreements similar to the auto pact. It could also involve more comprehensive trade liberalization — either within GATT or in a new Canadian-U.S. trade arrangement.

The Special Import Measures Act

Since the conclusion of the Tokyo Round in 1979, Canada has implemented its commitments to reduce tariffs and liberalize its methods of customs valuation and government procurement. At the same time, it has taken advantage of the opportunity provided by other GATT nontariff codes to toughen its protectionist legislation. The *Special Import Measures Act* (SIMA), passed in 1984, is a prime example. The act ac-

cepts, for example, a weak test of injury to domestic producers that is used in many countries and is approved by the GATT. Generally, SIMA contains considerable potential for the increased use of nontariff barriers in response to escalating protectionism abroad.

This is precisely the strategy recommended in a recent publication by Canadian economist Fred Lazar. After presenting a detailed exposition of the implications for Canada of U.S. protectionism, Lazar argues that the federal government should implement "mirror legislation" similar to that contained in U.S. trade law:

> Such legislation could be used as a protectionist device. However, its principal role should be as a bargaining lever in bilateral negotiations to open up markets for Canadian firms and offset retaliatory contingency protection measures against Canadian companies and Canadian government industrial policies.[23]

Lazar notes that this approach, which combines an active industrial policy buttressed by increased use of nontariff barriers, would violate Canada's GATT obligations. He argues that this is not an important consideration, however, because violations are common and are likely to continue due to the GATT's weak enforcement powers.

The problem with this approach is that it is likely to make matters worse, not better. To be successful, Canadian industry would have to rationalize production, increase research and innovation, and effectively penetrate foreign markets from a protected home market. It is unlikely that these results would be achieved for two reasons. First, protecting the domestic market for Canadian producers would actually reduce the incentive for Canadian firms to outperform their foreign competitors. Second, an industrial strategy that violates GATT rules would certainly elicit retaliation by Canada's trading partners. In fact, Richard Harris, in the Ontario Economic Council study discussed earlier, estimates the economic impact of several types of subsidies and industrial policies — including forced rationalization — and finds that even without foreign retaliation, such policies resulted in real income losses for the economy as a whole.[24]

This is not to say that Canada should totally eschew the use of nontariff protection and allow foreign protectionist measures to go un-

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[23] Fred Lazar, *The New Protectionism: Non-Tariff Barriers and Their Effects on Canada* (Ottawa: Canadian Institute for Economic Policy, 1982) p. 79.

[24] Harris and Cox, pp. 126–143.

challenged. For example, Canadian quotas on specialty steel imports implemented in early 1984 in retaliation to similar measures initiated in the United States may have had a beneficial impact by increasing U.S. awareness of the implications of its actions on Canadian-U.S. relations. The fact remains, however, that Canadian quotas hurt Canadian users of specialty steels. Thus, retaliatory measures of this type should be used only rarely and as a last resort.

The issue for 1985 is how to cope with continued protectionist pressures in specific sectors while at the same time taking steps to expand future Canadian access to foreign markets. Several investigations of Canadian imports under way in the United States could produce recommendations of quotas or countervailing duties this year. These investigations include one of U.S. fish imports from Canada to determine whether they are subsidized by federal aid to finance the restructuring of the East Coast fishery, and another to determine whether there are grounds for countervailing duties on British Columbia softwood-lumber exports to the United States — a move that was already defeated once, in 1983. Against this background of continuing sporadic trade conflicts, the Canadian and U.S. governments will commence discussions of more liberal trade arrangements between the two countries.

Sectoral Agreements with the United States

In the fall of 1983, the Canadian government proposed that Canada and the United States investigate the possibility of establishing bilateral free trade in such sectors as steel, urban transit equipment, agricultural implements and chemicals, and information services.[25] The supporters of the sectoral approach believe that such agreements could benefit both countries without raising fears of political absorption of Canada by its much larger trading partner. Talks between senior trade officials from the two countries were initiated in early 1984. In the United States, both the ITC and the Office of the U.S. Trade Representative plan to hold public hearings on sectoral free trade in early 1985 and to advise President Reagan of the results. In addition to the sectors already discussed between the two governments, the two U.S. agencies will assess the probable economic effects of free trade in furniture, wood and wood products, paper and paper products, cosmetics, and alcoholic beverages.[26]

[25] Department of External Affairs, *Canadian Trade Policy for the 1980s* (Ottawa: Supply and Services, 1983), p. 45.

[26] Jennifer Lewington, "Washington Ponders Implications of Closer Trade Ties with Canada," *Globe and Mail* (Toronto), November 20, 1984, p. 1.

In spite of these developments, however, the sectoral approach has lost momentum. Significant progress has been made toward an agreement on agricultural equipment, but in other areas work has bogged down as the complexity of industry-specific issues has become clear.

A major problem with the sectoral approach is that, by providing preferential treatment to bilateral trade in specific sectors, it violates the nondiscrimination principle of the GATT. Thus, any bilateral agreement would require a GATT waiver similar to that obtained when the two countries negotiated the auto pact in 1965. Given the rise of U.S. protectionism, it is doubtful whether the European Community, Japan, and other GATT signatories would approve such a waiver. Largely because of these difficulties, two influential groups — the Canadian Manufacturers Association and the Canadian Export Association — argue that Canada should seek more comprehensive trade liberalization.[27] It is, however, premature to dismiss the sectoral approach. If U.S. interest exists, it would be wise for the federal government to continue to investigate the benefits and costs of free trade within specific sectors as part of its review of Canadian options.

More Comprehensive Trade Liberalization

There are two ways in which Canada can work toward a more comprehensive reduction of tariff and nontariff trade barriers. The first is through another round of multilateral trade negotiations within the GATT framework. While such multilateral negotiations have served well as a mechanism for reducing tariff levels, they have been much less successful in curtailing nontariff protectionism. Indeed, as has been pointed out earlier, by establishing guidelines for the use of many types of nontariff measures, the Tokyo Round may actually have had the effect of legitimizing resort to such measures. The ability of another multilateral round to slow the growth of protectionism in the 1980s is limited by the fact that even if GATT nations wanted another round, it would be the late 1980s before negotiations could begin and the mid-1990s before the effects would be felt. Nevertheless, another GATT round is part of the U.S. government's strategy to reverse international protectionist trends. Canada's cooperation in assisting U.S. efforts to initiate another GATT round could be an important bargaining chip in resolving Canadian-U.S. trade disputes.

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[27] Barry Estabrook, "Sectoral Free Trade Campaign Under the Gun," *Financial Times of Canada*, October 15, 1984, p. 13.

The second avenue of approach is through a bilateral trade agreement with the United States. The apparent failure of the sectoral approach has focused attention on the possibility of entering into a much broader agreement. In the press, the issue is discussed under the heading "The Great Free Trade Debate". This is misleading. As Rodney de C. Grey argues,

> To propose that Canadian tariffs be removed unilaterally, that Canadian and U.S. tariffs be reduced by means of bargaining, or that Canada and the United States create a tariff-free zone are all specific propositions, well worth discussing on their merits. To propose "free trade" is to propose something much more complicated, much more difficult to understand, and perhaps not possible to achieve.[28]

Tariffs between Canada and the United States are already very low. By 1987, 95 percent of Canadian industrial exports will face tariffs of less than 5 percent in the United States, while 81 percent of U.S. industrial exports to Canada will face tariffs of 5 percent or less.[29] Although the elimination of remaining Canadian-U.S. tariffs would result in some beneficial rationalization and productivity improvement, it would not ensure free access for Canadian exports to the United States or vice versa.

Eliminating tariffs, rather than freeing trade, could result in much heavier reliance in both countries on nontariff barriers. The unfortunate consequences for Canada would be reduced domestic investment and job creation as Canadian companies shifted their investment to the United States, and slower adjustment in declining Canadian industries receiving nontariff protection. The European Community provides an example of the risk. Twenty-five years after its inception and the consequent elimination of internal tariffs, the growth of nontariff protectionism within the Community has led observers to call into question its continued existence as a meaningful entity.[30] Firms in the Community that had hoped to develop their products for the entire European market increasingly find themselves restricted by nontariff barriers to the movement of goods within the Community. An agreement to liberalize Canadian-U.S. trade could help to halt the drift to managed trade and inspire greater interest in Europe, Japan, and the developing world in another GATT round.

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[28] Grey, *Trade Policy in the 1980s*, pp. 4–5.

[29] Canadian Manufacturers Association, *A Future That Works* (Toronto: CMA, 1984), p. 39.

[30] André Bénard, *A Europe Open to the World: A Report on Protectionism and the European Community* (London: Trade Policy Research Centre, 1984), pp. 3–4.

To avoid this outcome, any agreement between Canada and the United States should put primary emphasis on bilateral negotiations to remove nontariff barriers. Full elimination of such measures would mean that the goods and services of each country gradually would be extended "national treatment" in the other's market. Canadian steel, for example, would be accorded the same treatment as domestic steel in the United States and would not subjected to the voluntary restraints imposed on other steel-producing countries. Similarly, U.S. products gradually would be given national treatment in Canada.

Other, less dramatic approaches to reducing nontariff protection — such as tightening the definition of injury — are possible, but are likely to have a much smaller impact. Whatever approach to bilateral trade liberalization is taken, however, its ultimate success will depend on the extent to which it comes to grips with nontariff protection.

Conclusion

Canadians, faced with the disappearance of a comfortable status quo with our trading partners, must choose between making our way independently in an increasingly protectionist world or taking specific initiatives to escape the negative consequences of nontariff barriers at home and abroad. For a country as dependent on trade as Canada, matching foreign trade restrictions with domestic ones is not a winning strategy. Canadians would be denied access to an international market large enough to sustain efficient scale production, and an important source of improved productivity and living standards would be foreclosed. The only alternatives, difficult as they may be, are those that overcome the protectionist threat to Canada by reducing, either sectorally or more broadly, nontariff measures affecting Canadian exports.

Debates in Canada over trade policy have a history of being politically divisive and, in the end, indecisive. The present debate will be fruitful only if the emotionalism that surrounds the issue can be defused. This will be achieved only if the proposals placed before Canadians deal with specific trade policy issues and not generalizations about "free trade". The debate in 1985 about Canada's trade relations with the United States should be viewed as part of an integrated strategy to restore Canada's growth prospects. Deficit reduction and a more flexible and competitive cost structure can create an environment for improved growth, but access to foreign markets is necessary to provide the incentive for private-sector investment and job creation.

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Taking Decisive Action

Canada is at a crossroads. To take the way that leads to long-term economic success will require tough-minded choices and decisive leadership. Because of its large majority in Parliament, the Progressive Conservative government is in an excellent position to provide such leadership. It can turn the working drawings for a new economic strategy into successful action if it has the will to do so.

The Institute believes the necessary strategy should consist of three main elements:

- reduction of the federal deficit by $15–20 billion by the end of the decade, mainly through expenditure reductions;
- negotiation of expanded access for Canadian exports to the U.S. market, and to others if possible; and
- creation of a climate for growth that encourages entrepreneurship, reduces regulation, and improves functioning of the labor market.

Commitments made since the September 1984 elections to reduce the federal budget deficit are too small to carry out the adjustments required; the government itself recognizes that. More will have to be done. Actions to improve short-term economic and employment performance will be insufficient if the threat to Canada's trade prospects is not addressed. Canada's investment prospects could be a major casualty of continuing fears of protectionism.

The temptation to maintain the status quo should be overcome by the realization that there exists a set of inexorable, long-term consequences of inaction. For example, if the federal deficit is not dealt with now, compounding interest rates will inevitably — and soon — force draconian action to curb the growing debt-servicing bill. Attempting to push down interest rates in the short term instead of dealing with the causes

of savers' reluctance to lend at lower rates may be popular, but the consequences of abandoning the long-term strategy of controlling money growth would be to raise interest rates even higher. Pushing down the exchange rate rather than dealing with our costs and competitive position, is a high-risk strategy for a debtor nation such as Canada. In the end, the exchange rate will have to be defended, but at a lower and more costly level. In short, taking realistic action now to deal with the causes, rather than the symptoms, of our economic problems is the smart as well as the courageous thing to do. It will have to be done eventually, in any case.

The Key Role of U.S. Economic Policy in 1985

U.S. economic policy is likely to be a key factor affecting the strength of the world economy in 1985. In 1984, participants in financial markets expected that President Reagan, following his re-election, would take tough measures to reduce the U.S. budget deficit. By the end of 1984, however, a slowdown in the U.S. economy and the president's own interpretation of his election promises not to raise taxes contributed to uncertainty about action on this front. But failure to act also carries high costs, and this fact alone provides grounds for optimism that a compromise will be reached in 1985.

After growing at a rapid rate in the first half of 1984, the U.S. economy slowed significantly in the second half of the year as part of a transition to a more sustainable rate of growth. The economy's underlying strength was already beginning to reappear by year-end. But slow growth continuing in the first half of 1985 could be helpful to efforts to bring down the U.S. budget deficit since it would then be clear that growth will not, by itself, solve the problem. The deficit declined to $175 billion in the 1983–84 fiscal year, but then began to climb again. The Reagan administration expects the deficit to reach $210 billion in the 1984–85 fiscal year, even if the economy grows at a 4 percent rate.[1]

The administration's target, announced after the November election, is to reduce the deficit to $100–150 billion annually, or to 2–3 percent of GNP by 1988. To achieve this target, about $100 billion will have to be cut from the annual deficit by 1988 and significant action will have to be taken in 1985. The task will be made more difficult if the president refuses to compromise on election pledges to reduce the deficit by

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[1] Jonathan Fuerbringer, "Goal of '88 Deficit Under $150 Billion Reportedly Set," *New York Times*, November 17, 1984, p. 1.

$100 billion without a tax increase or substantial cuts in defense spending or social security. To carry out these promises, the entire reduction would have to be found in a group of nondefense spending programs that will total only about $400 billion in 1988. Congressional resistance to further nondefense spending cuts is likely to be stiff and to produce a political stalemate.

Opportunities for compromise exist. For example, the president could reduce growth in defense spending, impose a tax on gasoline, or seek a consensus on tax reform. Declining inflation and the possibility of progress in disarmament talks with the Soviet Union could mean that there will be scope for a reduction in defense spending. Proposals for tax reform submitted by the Secretary of the Treasury include reduced tax rates and sweeping cuts in tax deductions and credits. A lengthy debate on the proposals is likely, but a package of tax reforms that encourages capital formation and individual initiative could generate substantial new revenue without any tax-rate increases.[2]

A lengthy political stalemate would undoubtedly have negative consequences for the world economy. The prospect of escalating deficits would undermine confidence in the Federal Reserve Board's ability to resist pressures to monetize the debt. The resulting increase in inflationary expectations would erode the confidence of foreign investors who have been helping to underwrite the U.S. expansion by acquiring U.S. business and government debt. The risk is that a substantial blow to confidence in U.S. policy would make foreign investors reluctant to absorb increasing volumes of U.S. debt, unless the Federal Reserve Board caused U.S. interest rates to rise. Higher interest rates would again weaken U.S. economic and investment opportunities, with harmful consequences for other industrial countries, including Canada, and for heavily indebted developing nations.

This outcome would be in no one's interest. Both the administration and Congress want to avoid it by achieving a compromise on deficit reduction. The shape of that compromise cannot be forecast; it will be the product of hard political bargaining. But recognition that the U.S. deficit problem must be dealt with in 1985 provides grounds for optimism that a solution will be found that includes a combination of spend-

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[2] For two views on the tax reform proposals, see Walter W. Heller, "A Rocky Road to Tax Reform," *Wall Street Journal*, November 28, 1984, p. 26; and Paul Craig Roberts, "A Tax Scheme to Deindustrialize America," *Wall Street Journal*, December 6, 1984, p. 30.

ing cuts and revenue increases.[3]

Strategic Directions for Canadian Policy

Despite uncertainty about U.S. deficit cutting, the federal government must take action now to improve growth prospects for the rest of this century. Only a major shift in emphasis in Canadian economic policy — away from failed attempts at macroeconomic stimulus and toward a concerted strategy of structural and trade policy initiatives — can succeed in generating the climate of confidence that will push the economy onto a higher growth path.

Macroeconomic policy, important as it is, cannot directly ensure that the Canadian economy becomes more productive, more dynamic, and more internationally competitive. It can, however, contribute to a climate conducive to business entrepreneurship and investment. Governments also affect the climate, often in more direct ways, through their determination of industrial, labor-market, and trade policies. But governments set these policies largely in response to pressures from the private sector. There can be no climate for renewed growth, therefore, without recognition from the private sector that an across-the-board reduction in intervention could make all Canadians better off. This can only happen if business, labor, and consumer groups who regularly visit the national and provincial capitals to push for intervention, protection, or increased regulation, take a national perspective in their consultations with governments in the budget-making process.

The objective of reduced intervention by governments is to create an environment in which Canadian firms can thrive or fail based on a market test of how competitive and innovative they are. Canada's past practice of protecting companies on the edge of bankruptcy, both from imports and from domestic competition, has served only to freeze labor and capital resources in industries with little prospect of future growth and to raise the costs of the inevitable adjustment. This does not mean that governments should ignore the hardships caused by bankruptcies and layoffs. On the contrary, they should focus even greater attention on the individuals, rather than the companies, affected by changing market conditions. In labor markets, the problem is not that people lose their jobs because

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[3]This view has been expressed by the former chairman of the Council of Economic Advisors, Martin Feldstein (see Paul Blustein and Jane Mayer, "Fiscal Impasse: Deficit Dispute Seems Headed for a Stalemate Unless a Crisis Looms," *Wall Street Journal*, November 28, 1984, p. 1).

of changes in the economic environment but, rather, that the economy and economic policy are not sufficiently flexible and dynamic to reemploy them in a short period of time.

Building that dynamism and flexibility into the economy is the task of all Canadians. Governments can provide a stable climate, but it is up to individuals in Canadian corporations, labor unions, and small businesses to adopt a more positive attitude toward change. Without such an attitude, growth-oriented structural policy changes — those designed to encourage entrepreneurship, instill greater flexibility in the labor market, and expand export markets — will not be effective.

Creating a Climate for Entrepreneurship

Economists recognize the importance of risk-taking and entrepreneurship in the process of economic growth. Keynes, for example, stressed the importance of entrepreneurial "animal spirits". Formal economic analysis, however, has never come to grips with the question of how this essential element of economic development can be encouraged. Entrepreneurship is a process of implementing innovations that lower production costs and change markets by providing goods and services of better quality at lower prices. For a public policy of reduced intervention in the economy to succeed, the private sector will have to fill the gap with increased entrepreneurial activity and job creation. Yet the factors in the economic environment that encourage risk-taking are not as well understood as they should be. There is a growing understanding, however, that a number of impediments to entrepreneurship exist in Canada. These include:

- overprotection of existing businesses in declining industries;
- insufficient access to venture capital;
- restrictive regulations on the investment behavior of large capital pools such as pension and insurance funds;
- the complexity of the tax system;
- insufficient public recognition and encouragement of entrepreneurial successes; and
- insufficient training in entrepreneurial skills.

To define adequately the appropriate role of government in the encouragement of entrepreneurship requires consultation with small business groups in Canada and examination of successful entrepreneurial

incentives in other countries. There is a risk that, because the entrepreneurial process is poorly understood, pressures will build for tax incentives or government programs that will merely increase the deficit with little effect. Such pressures should be resisted, but tax simplification, regulatory, and training policies, as they affect small, innovative businesses, should be developed and implemented.

Excessive government intervention also stifles entrepreneurship. The clearest example of such policies exists in the Canadian petroleum sector, where government agreements, rather than the market, set prices, and a complicated system of government grants and tax incentives distorts investment and production decisions. Movement to market prices and creation of more neutral investment incentives could spur activity in this important sector of the Canadian economy.

Re-employment Policies

Unemployment is a serious policy concern. A decade of experience has shown that the solution is not government job-creation schemes but, rather, a flexible and competitive private sector. It seems clear that the policy priority should be to change the system of compensation and human-resource development to assist both employers and employees to become more responsive to economic change. Such a strategy should aim to:

- *Encourage gain sharing and training leave.* Canadians are more likely to accept change if we believe we have a direct stake in the potential benefits. Employees will resist technological change unless they receive some of the benefit from investments that increase their productivity. Voluntary gain-sharing agreements could spread the benefits of improved productivity more evenly among employers and employees. By creating a common goal, such agreements could make a valuable contribution to improved competitiveness in Canadian industry.

Another method of sharing the gains from technology is for employers to devote some of the time saved from implementation of labor-saving devices to retrain employees for new tasks. Increased educational or retraining leave, with the costs shared by industry, government, and employees, would increase employment demand at the same time as it continually upgrades the skills of the labor force.

- *Eliminate the long-term unemployment trap.* Short spells of unemployment are a necessary feature of a dynamic economy. In Canada, however,

over half of the current unemployment rate is accounted for by people unemployed for six months or longer. After long spells of unemployment, these people lose their skills and confidence. The relatively generous benefits and liberal eligibility criteria of Canada's unemployment insurance (UI) system encourage dependence and trap an increasing number of Canadians in a cycle of unstable work and long-term unemployment.

There is an alternative: to change the system, in two ways. First, there should always be an incentive to accept a job. Conditions upon receiving UI benefits should not discourage people from accepting part-time work or enrolling in a training program. Second, after six months of unemployment, people should be given a choice between enrolling in a training program or doing community-service work while they continue to receive UI benefits. No one should be forced to accept either of these options, but those who refuse ought not to be able to collect full unemployment benefits for long.

Federal and provincial governments, industry, labor unions, and training institutions should engage in a joint effort to expand training programs. The objectives would be to reduce functional illiteracy — an important contributor to unemployment — and to provide a better match between the skills employers require and those the unemployed possess. Increased emphasis on community service would be especially appropriate for young people seeking experience in a working environment. Apprenticeship in nonprofit organizations, hospitals, police and security agencies, and local governments, could provide skills and useful experience.

Trade Policy

The process of economic change and restructuring facing Canada will be more fluid and will cause less dislocation if market opportunities expand as well. For a trading nation like Canada, which already generates one-third of its national income from the sale of exports, obtaining secure and growing markets abroad is essential to its investment prospects and to raise individual living standards. The protectionist world trading environment increases the importance of improving access to world markets for Canadian exports.

Canada has benefited significantly from the multilateral tariff reductions achieved under the auspices of the General Agreement on Tariffs

and Trade (GATT). Because tariffs have now been reduced to relatively modest levels, future GATT negotiations are likely to deal much more with reversing the rising use of nontariff barriers to international trade. Canada has much to gain from a multilateral agreement to restrict such barriers and should join with the United States in actively pursuing a new round of GATT talks. Realistically, however, a new GATT round is unlikely to yield concrete results in this decade.

Thus, a trade deal with the United States is a major priority. Improved access for Canadian exports to the U.S. market would provide a strong incentive for Canadian firms to restructure their production to achieve not only world-scale size but also the lower costs and improved competitiveness that would result. Improving access to this market should focus on getting around the expanding web of U.S. nontariff barriers. To achieve this, Canada would have to exempt U.S. goods and services from Canadian nontariff barriers. Each country's products would have to be given "national treatment" in the other's market. Further tariff reduction could also be negotiated, although this may be less important and potentially more difficult to achieve.

Both the Canadian and U.S. governments have indicated a desire for improved and expanded relations between the two countries, and both are seeking ways to reverse protectionist pressures. Moreover, as a result of recently held national elections, both have been given strong political mandates. The unique opportunity available in 1985 to negotiate freer trade arrangements with the United States may not exist in 1986, particularly if the U.S. economy is in recession as the president begins to look toward the political pressures of mid-term elections. The ball is in Canada's court. The federal government must decide soon to grasp this historic opportunity, begin the necessary consultations in Canada, and proceed quickly with a proposal to the United States.[4]

Canadians should also realize that a major bilateral initiative could have potentially major international consequences. The prospect of assured access to the U.S. market could increase substantially the interest of foreign investors in Canadian production. The perceived threat of closer North American economic ties also could be sufficient to interest many countries in a new GATT round aimed at further multilateral trade

[4] Richard G. Lipsey examines Canada's trade policy options, with particular emphasis on the potential for freer Canadian-U.S. trade, in a forthcoming C.D. Howe Institute publication.

liberalization, something that is in the interests of both Canada and the United States.

The Role of Macroeconomic Policy

Within a strategy to improve Canada's long-term growth prospects, the main objective of macroeconomic policy is to stabilize short-term growth and price-level performance. This means the pursuit of employment objectives not by the injection of fiscal or monetary stimulus but by the creation of a stable environment for private-sector growth. In 1985, stabilization policy should focus on reduction of the federal budget deficits projected over the next five years.

Fiscal Policy: Dealing with the Deficit

The accumulation of public debt created by a decade of budgetary deficits has left the federal government in a highly constrained fiscal position without room to maneuver. Finance Minister Wilson understood this when he stated,

> prudent economic and financial management demands government action now to stop the federal debt from growing faster than the economy. The need for such action is not a matter of ideology. It is an inescapable reality we have to deal with.[5]

Although the issue is no longer *why* the deficit must be reduced but *how*, the reasons why are worth repeating.[6] Projected federal deficits of $35–40 billion each year until the end of the decade would seriously harm Canada's growth prospects. By increasing the federal public debt faster than the economy is growing, these large deficits would absorb an increasing share of Canadians' savings, reducing the amount available for the private investment needed for growth. Some Canadian companies could borrow abroad to finance their investment, but this increased foreign borrowing would push up the value of the Canadian dollar and reduce activity and employment in export- and import-competing sectors of the economy.

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[5] Hon. Michael H. Wilson, *A New Direction for Canada: An Agenda for Economic Renewal* (Ottawa: Department of Finance, November 1984), p. 19.

[6] For a discussion of why the deficit should be cut, see Neil Bruce and Douglas D. Purvis, *Evaluating the Deficit: The Case for Budget Cuts*, Policy Commentary no. 4 (Toronto: C.D. Howe Institute, 1984).

Rising public debt would also increase interest payments to service the debt, thus creating two kinds of pressure. The first is to cut other types of spending or raise taxes to prevent the deficit from rising further. The second is to finance the deficit by printing money — a factor which would raise inflation expectations and interest rates.

Canadians still do not recognize the seriousness of the federal government's deteriorating fiscal situation. The realization that we must make some unpalatable choices in 1985 to determine how the deficit will be cut or risk poor growth and the possibility of a debilitating fiscal and economic crisis in the years ahead, remains absent from public discussion.

The reaction to the expenditure cuts announced in the government's November Statement illustrates the point. These cuts, which total $4.2 billion in the 1985–86 fiscal year, represent only a modest beginning in dealing with the deficit. They will do no more than keep the deficit from escalating above $35 billion. Yet even these small steps have raised a public outcry from affected interest groups. The public discussion of spending cuts so far indicates widespread confusion about the government's objectives and its proposed methods of achieving them. These cuts reflect not a desire to have less public television, less environmental protection, or less path-breaking research in Canada but, rather, are an essential part of a program to restore fiscal stability. Much deeper spending cuts or tax increases will be necessary in the spring budget.

In August 1984, the Institute estimated that the deficit projected at that time would have to be reduced by $11 billion by 1988 just to keep the growth of federal debt from exceeding the growth of national income.[7] Just as a thermometer can be useful in establishing the health of patient, the ratio of debt to GNP can be used to gauge the financial prudence and stability of the government's budget plans. This ratio measures what the government owes relative to the ability of the economy to generate income. As the ratio increases, other things being equal, an increasing proportion of federal revenue is required simply to pay interest on the accumulated debt. Figure 4 shows the rapid growth in the debt-to-GNP ratio since 1975. The federal debt has been doubling every three years since 1975 and is expected to double again over the next four years. National income takes more than twice as long to double and is expected to increase by 30–35 percent during the next four years. Consequently, interest payments on the federal debt now absorb 33 cents of every

[7] Edward A. Carmichael, *Tackling the Federal Deficit*, Observation no. 26 (Toronto: C.D. Howe Institute, 1985), pp. 7–9.

dollar of budgetary revenue, and this figure will go higher if interest rates do not come down further.

The Institute's suggested $11 billion target represented the minimum deficit reduction required by 1988 just to stabilize the ratio of federal debt at about 40 percent of GNP, the level reached in the 1983–84 fiscal year. But this estimate was based on the government's February 1984 deficit projections. Calculations based on the much higher deficit projections published with the November Statement indicate that stabilizing the ratio of federal debt at this level now would require that the currently projected deficit for 1988 be reduced by $25 billion. The $10–15 billion reduction in federal spending by the 1990–91 fiscal year promised in the Statement suggests that the government has adopted a less-ambitious target. If these spending cuts produced an equal reduction in the deficit, the ratio of federal debt to GNP would stabilize at about 50 percent by 1991.

The measures the Institute outlined in August 1984 to reduce the federal deficit could meet the government's spending-reduction target. The government has already adopted some, including cuts in economic development and energy subsidies, increased user fees for government services, reduced grants to Crown corporations, and tighter management of programs. These are steps in the right direction but, as the government has acknowledged, they are only the first steps.

So far, the federal strategy has focused exclusively on the expenditure side of the budget. This focus is appropriate because many federal programs have not yet been scrutinized carefully to establish whether they are achieving their objectives. The financial imperative of deficit reduction, combined with public resistance to higher taxes, suggests that a reassessment is necessary of the role of government in Canadian life. Spending programs that survive this type of scrutiny should be those that are well-designed and serve broadly shared objectives.

While it is possible to cut the deficit entirely on the expenditure side of the budget, the Institute's earlier analysis concluded that achieving the target deficit reduction in this way would require cuts in all areas of government spending, including social programs.[8] Table 5 shows updated estimates of an "expenditure-only" strategy similar to the federal government's proposal to reduce the deficit by $15 billion by the 1990–91 fiscal year. These estimates suggest the depth of spending cuts in specific program areas that would be required to achieve the target.

[8] Ibid., p. 9.

TABLE 5
An "Expenditure-Only" Deficit-Reduction Strategy

Policy area or program	Current expenditure projection for 1991[a] ($ billions)	Possible expenditure reduction by 1991 ($ billions)
Economic and regional development[b]	17.7	3.0
Social development[c]	56.1	6.0
pensions	16.5	0.6
family allowance	3.0	1.0
unemployment insurance	1.4	0.8
direct social spending	17.3	1.7
transfers to provinces	16.9	1.9
Defense and foreign affairs[d]	17.0	1.0
Public debt interest	34.0	3.0
Other	13.0	2.4
Total	*137.9*	*15.4*

[a]Projections by the C.D. Howe Institute, based on the February 1984 *Fiscal Plan* and the November 1984 *Economic and Fiscal Statement*.
[b]Includes spending allocated to the Economic Development and Energy envelopes.
[c]Includes spending allocated to the Social Affairs, and Justice and Legal envelopes.
[d]Includes spending allocated to the Defence, and External Affairs and Aid envelopes.

Source: C.D. Howe Institute.

Spending reductions on economic and regional development programs should focus on those program expenditures and subsidies that distort market signals, thereby blocking economic adjustment. Options include reducing the size of grants under the Petroleum Incentives Program, further scaling down the Industrial and Regional Development Program, and reducing subsidies in the transportation and agriculture sectors. Adopting these options could generate expenditure savings of $3 billion by 1991, which represents a cut of about 17 percent compared with current plans for spending on economic and regional development.

The government has limited scope for expenditure savings in defense and foreign aid programs because of two international commitments: to fulfill Canada's responsibilities as a member of NATO by modernizing the armed forces, and to increase official development assistance to 0.7 percent of GNP. By stretching these commitments out over a longer period of time, however, the government could cut $1 billion from currently planned levels.

Other potential areas for expenditure reduction include the sale of Crown corporations, particularly those that are an ongoing financial drain

on the public's purse, and reducing the size of the public service in line with program cuts and improved management efficiency.

Significant as these cuts are, they represent only about half of the government's target. Some cuts in social spending also will be required. These should focus on imaginative reforms designed to improve the effectiveness and reduce the cost of social programs. Improved targeting of federal pensions and family income security programs could generate significant savings, as could reforms to unemployment insurance such as those discussed in Chapter 2.[9] A discussion paper on some of the main issues and options is expected from the government early in 1985. Ways would also have to be found to reduce direct social expenditures and to fund health, education and social welfare programs at reduced federal spending levels. If the government adopted all of these changes, it could cut spending on social programs by $6 billion, or about 10 percent, by 1991. Combined with those in other areas, such cuts would contribute to slower growth in the federal debt and generate savings of an additional $3 billion on public debt interest.

Cutting the deficit on the revenue side of the budget will also require careful examination of the available options. This analysis should begin in 1985, when the government introduces its planned discussion paper on tax reform. The large increase in budget deficits projected in the November Statement over those projected in the February 1984 budget was almost entirely the result of a downward revision in federal revenue expectations. In fact, lower revenue projections accounted for $8 billion of the $9 billion increase in the newly projected deficit for the 1987–88 fiscal year.[10] Such reduced expectations are only partly the result of a weaker economic forecast; tax collections are falling short of expectations, probably because an accumulation of special tax deductions and tax credits is eroding the federal tax base.

It remains imperative, however, to tackle the spending side of the budget first. Adopting a strategy such as that proposed by the Economic Council of Canada, which favors an immediate increase in personal income taxes, would only forestall a badly needed review of all areas of

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[9] Expenditure savings on unemployment insurance referred to in Table 5 relate only to reductions in the federal government's contribution. Reforms that lead to improved functioning of the labor market and reduced unemployment could also lead to reduce employer and employee contributions to the program.

[10] Wilson, p. 10.

federal government spending.[11] Once it has undertaken such a review and has completed consultations on the issues with affected groups, the government should then decide how much of the deficit reduction will come from expenditure cuts and how much from tax increases.

Monetary Policy: Maintaining Stability

Because of the unacceptable risks to long-term economic growth posed by large and rapidly growing public debt and debt-servicing costs, Canada will have to reduce its deficit regardless of what other countries do. Therein lies a major policy dilemma. The short-term impact of deficit reduction, by itself, is likely to be contractionary.

The Institute has argued that the contractionary effect could be offset if the conduct of monetary policy is closely coordinated with measures to reduce the deficit.[12] This argument is based on the empirically validated hypothesis that both fiscal and monetary policy are "blunt instruments" that influence the short-term growth of nominal GNP.[13]

According to the Bank of Canada, the goal of monetary policy is to:

> achieve that rate of monetary expansion which best serves the needs of the economy, and that is a rate which does not give rise over time to tendencies towards either a decline in prices generally (deflation) or a rise in prices generally (inflation).[14]

The Bank has pursued this objective by controlling interest rates and monetary expansion in such a way as to bring about a gradual reduction in the rate of growth of nominal GNP. A commitment by the Bank to continue to pursue a gradually declining nominal GNP target would, by definition, guarantee a monetary policy that offsets the contractionary impact of deficit reduction. But what would such a monetary policy entail?

The answer to this question can be found by tracing the expected ef-

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[11] Economic Council of Canada, *Twenty-First Annual Review: Steering the Course* (Ottawa: Supply and Services Canada, 1984), p. 87.

[12] See Carmichael, p. 7; and "Time for a Strategic Economic Agenda," *C.D. Howe Institute Commentary* (September 1984), p. 4.

[13] See, for example, David T. Coe and Gerald Holtham, *Output Responsiveness and Inflation: An Aggregate Study*, OECD Working Papers no. 6 (Paris: Organisation for Economic Co-operation and Development, April 1983), p. 3.

[14] Bank of Canada, *Annual Report of the Governor, 1983* (Ottawa: Bank of Canada, 1984), p. 6.

fects of reducing the deficit. The critical determinant of the appropriate monetary policy response is what happens to the Canadian dollar.[15] There are two possibilities. The first, and the one that was reflected in the Statement, assumes that a credible deficit-reduction strategy would both restore private-sector confidence in Canada's attractiveness as a place to do business and defuse concerns that the debt might, in the longer term, be monetized, which would be inflationary. In the medium term, this improved management and performance of the Canadian economy could be expected to attract foreign capital flows and reduce capital outflows, with resulting upward pressure on the Canadian dollar in relation to other currencies. According to this view, the Bank of Canada could slow the upward movement of the dollar and allow interest rates to move downward, action which could be expected to further encourage private-sector activity.

The second possibility is one that is reflected in most conventional economic models. It incorporates no confidence effects and assumes that fiscal restraint would reduce the growth of nominal aggregate demand. To maintain the target growth rate of nominal GNP, the Bank of Canada would have to permit Canadian interest rates to decline in order to offset fiscal restraint. This decline in interest rates would cause the dollar to weaken relative to other currencies. Lower interest and exchange rates could then be expected to stimulate interest-sensitive domestic spending and boost net exports in order to restore nominal GNP growth to its targeted level.

The difficulty with allowing interest rates and the Canadian dollar to decline is that participants in financial and foreign-exchange markets may mistakenly view the easier credit conditions as an easing in the longer-term conduct of monetary policy. This could lead to speculative moves to exchange Canadian for U.S. dollars, which could push the value of Canadian currency below that which reflects economic fundamentals. Should this occur, the Bank of Canada would face a difficult choice between raising interest rates and allowing the depreciation to occur. The Bank would, therefore, have to walk a fine line to balance the need for continued economic expansion against the risk of increased inflation.

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[15] The exchange rate most relevant to the conduct of monetary policy is not the Canadian-U.S. exchange rate, but rather the effective exchange rate shown in Figure 3, panel D. The effective rate takes account of the value of the Canadian dollar vis-à-vis Canada's main competitors in world markets.

Depreciation of the Canadian dollar, however, does not represent a lasting solution. The top priority of monetary policy in 1985 should be to ensure that the economic and financial stability and noninflationary economic expansion that began in 1983 lasts for several more years. In the extended period of fiscal restraint that lies ahead, the objective of the Bank of Canada should be to conduct monetary policy so that the configuration of monetary expansion, interest rates, and the exchange rate accommodates real growth without rekindling inflationary pressures.

Conclusion

Charting a new course for economic policy can often be a basic test of political leadership. In 1985 the stakes are high. The wave of change sweeping through the world economy cannot be resisted. It carries with it terrific challenges and tremendous opportunities, as Canadians are beginning to realize.

In this rapidly evolving environment, the federal government is wise to use the widespread consultative exercise it has initiated. But it should recognize the risks of consultation as well. Those who tend to participate are, by the nature of the process, those who have arrived at the top of their respective fields. Inevitably, they are the people who achieved success yesterday. The people who will record tomorrow's triumphs are as yet unknown. Thus, the participants at summits tend to be people with heavy interests in today's way of doing things.

The test for Canada's political leadership is to look to the future, not to the status quo. Decisions that seek consciously to shape and improve that future, instead of merely reacting to the past, are likely to be lonely ones. They will separate the true leaders from those who dare only to be popular. Canadians must come to realize that expediency can only briefly postpone the inevitable.

A start was made in this new direction in 1984. The debate and consultation initiated by the November Statement touched on a wide range of policy issues. We think the priorities on which First Ministers and the participants in the national economic conference scheduled for March 1985 should focus are the following:

- The federal deficit must be reduced by $15–20 billion by the end of the decade. The issue is how. The federal government proposes to cut spending by $10–15 billion by 1991. Consultation should focus on the tradeoffs that have to be made among specific public spending priorities

and programs. A wide range of measures will be required, including better program targeting, privatization, increased user fees for government services, and reduced tax expenditures.

- To reach the higher deficit-reduction target that the Institute thinks is now required, the federal government will also have to increase its revenues. The issue for consultation is how to do this in ways that do not discourage private-sector initiatives.
- The fundamental issue of trade policy is to neutralize the threat of international protectionism and to expand access to foreign markets. Growing protectionist threats in the United States could inhibit investment in Canada for some time to come. Consultation should focus on the initiative Canada should take to assure more favorable access to the U.S. market and on the adjustments that would be required. Canadians will not be able to gauge U.S. interest in freer trade until we take the initiative.
- The prospects for re-employing Canadians can be improved by freeing up financial resources for growth through deficit reduction, but making the most of the opportunity will require that greater emphasis be placed on improving the functioning of labor markets. The issue for consultation is how employers, entrepreneurs, labor, and government can work together to increase the competitiveness and adaptability of the Canadian economy.

After the talking is over, Canada's leaders must act. Canadians cannot then sit back, either. If the courageous route is taken, many Canadians will doubtless be tempted to criticize, to raise the tired old arguments against change, and to oppose shouldering their fair share of the needed adjustments. But there is no one but the next generation to whom to pass the burden. Some groups, such as Canada's manufacturers and small businessmen, have shown their confidence and competitive attitudes by moving from opposition to support of trade liberalization with the United States. They are ahead of their leaders, but they — and all Canadians — will have to get behind them as well. If Canada's political leaders have an obligation to govern in a far-sighted way and to implement imaginative policies, the Canadian public has a matching responsibility to rise to the challenges of tommorow. Whether we like it or not, all Canadians must grapple with the discomforts of an unfamiliar but better and more interesting world.

Policy Analysis Committee

The C.D. Howe Institute Policy Analysis Committee (HIPAC) was formed in 1980 from the Canadian Economic Policy Committee, establish in 1961. This change was brought about to help streamline the Institute's activities and to improve the process of accountability of staff to the Institute's members.

HIPAC's membership is drawn primarily from business and labor organizations that are members of the Institute. To encourage diversity of perspective, HIPAC also includes members from the academic world, from agricultural organizations, and from the professions. Two Regional Advisory Committees have been established across the country to assist HIPAC in determining its research agenda and to ensure that the research conducted by the Institute on its behalf is relevant and reflective of regional points of view.

Full meetings of HIPAC's membership are held twice each year. The purposes of these meetings are to hear expert speakers on current policies, to engage in frank discussion of topics raised by members, and to identify a research program that the Institute can effectively carry out to improve public understanding of important policy issues. The professional completion of this program is then supervised by the Institute, which coordinates with the HIPAC Executive Committee.

The Chairman of HIPAC is H.A. Hampson (President and Chief Executive Officer, Canada Development Corporation).

Recent publications prepared in conjunction with HIPAC include:

- *Education Policy in Canada: The Urgent Issues*. C.D. Howe Institute Commentary, by Claude E. Forget (February 1985).
- *Time for a Stategic Economic Agenda*. C.D. Howe Institute Commentary, by Wendy Dobson and Peter Bartha (September 1984).
- *National Consultation: Problems and Prospects*. Policy Commentary no. 5, by John Crispo (September 1984).
- *Tackling the Federal Deficit*. Observation no. 26, by Edward A. Carmichael (August 1984).
- *Evaluating the Deficit: The Case for Budget Cuts*. Policy Commentary no. 4, by Neil Bruce and Douglas D. Purvis (July 1984).